U.S. Department of Justice

Office of Legislative Affairs

Office of the Assistant Attorney General *Washington, D.C. 20530*

February 9, 1998

The Honorable John Dingell
Ranking Minority Member
Committee on Commerce
U.S. House of Representatives
Washington, DC 20515

Dear Congressman Dingell:

This responds to your letter to the Attorney General concerning recent media reports about so-called chop stock schemes. In the typical chop stock scheme, investors are defrauded through purchases of stock issued by micro cap (thinly capitalized) companies and sold by securities firms that obtain the stock at a small fraction of the price ultimately paid by victim investors.

Your letter indicates that you have also written to the Securities and Exchange Commission (SEC) and the National Association of Securities Dealers (NASD). As the primary regulatory and self-regulatory authorities, respectively, they are uniquely qualified to offer an assessment of the chop stock problem.

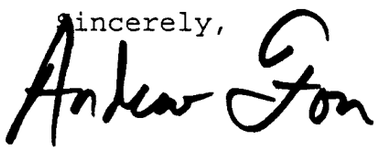
The Department has responded forcefully to the abuses associated with chop stock schemes. In recent weeks, United States Attorneys' Offices in five districts have brought charges related to micro cap schemes. On January 12, a New York City stockbroker became the fifth defendant to plead guilty to criminal charges in a micro cap stock fraud case prosecuted in the Eastern District of Virginia and the District of Nevada. Cases brought late last year include charges in the Eastern District of New York against eighteen individuals in two micro cap market manipulation schemes, a similar case in the District of New Jersey and an indictment of nineteen defendants in the Southern District of New York on racketeering and securities fraud charges. Another thirty-seven defendants, including brokers, stock promoters and issuers, have been indicted in the Southern District of New York for paying bribes to promote the sale of micro cap stocks to investors.

In addition to these cases, the Department has conducted over the past two years its Rogue Broker initiative, a nationwide series of prosecutions directed against unscrupulous brokers who prey upon unsuspecting investors. Last May, the Attorney General announced a second wave of Rogue Broker prosecutions against a total of seventeen brokers who had cheated their customers.

We view the chop stock schemes as a fusion of various abuses in the securities industry that the Department is aggressively investigating and prosecuting, sometimes as wide-ranging micro cap-related schemes and other times as more tightly focused market manipulation, broker bribery, and offering misrepresentations prosecutions. We thus believe that our enforcement efforts are responding effectively to these and other criminal schemes that victimize investors and threaten the integrity of our securities markets.

Thank you for your interest in the Department's securities fraud enforcement program. Please do not hesitate to contact the Department if we can be of further assistance with regard to this or any other matter.

Sincerely,



Andrew Fois
Assistant Attorney General

cc: The Honorable Thomas J. Bliley, Jr.
Chairman

The Honorable Michael G. Oxley
Chairman
Subcommittee on Finance and Hazardous Materials

The Honorable Thomas J. Manton
Ranking Minority Member
Subcommittee on Finance and Hazardous Materials

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

THE CHAIRMAN

February 9, 1998

The Honorable John D. Dingell
Ranking Member
Committee on Commerce
U.S. House of Representatives
2322 Rayburn House Office Building
Washington, D.C. 20549

Dear Congressman Dingell:

This is in response to your letter of December 12, 1997.

Like you, I view as unacceptable the possibility that any segment of this nation's securities markets has become rife with fraud and abuse. Protecting investors and combating fraud will always be at the core of the Securities and Exchange Commission's work. That is especially true for fraudulent conduct that is specifically designed and targeted at this country's growing population of vulnerable and inexperienced investors. American securities markets are the envy of the world because they are honest, fair and successful. Every member of the SEC staff is committed to using all the tools at our disposal to keep them that way.

Attached to your letter was a copy of a story that appeared in the December 15th issue of Business Week. In the wake of that article, you asked us to report on three specific issues. The first was to evaluate the extent of the so-called micro-cap fraud problem. The second was to describe the Commission's ongoing efforts to address this type of fraud. The third was to set forth our future plans to try to prevent such frauds from emerging.

The staff has prepared a memorandum that outlines our ongoing effort to respond to each of these questions. As you will see, we are making every effort to swiftly and forcefully address every issue that arises in connection with these fraudulent and abusive schemes. That is true regardless of whether these fraudulent practices involve "micro-cap" securities, "chop stocks," "penny stocks," or something else. I have called upon senior SEC staff members from every relevant office and division and given them a straightforward mandate: to develop short and long term plans to prevent such schemes from developing and, if such schemes proceed anyway, to promptly detect and vigorously prosecute them.

As outlined in the memorandum, some of our efforts are already bearing fruit. As you know, Commission staff have conducted numerous surprise inspections of small broker-dealers that had been subject to a disproportionate number of investor complaints. Our examination and inspection team has been provided special training and taught specific new procedures to help insure that documents and other materials are not improperly concealed or destroyed during an inspection.

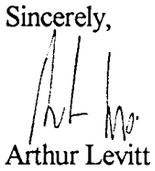
A critical component of our prevention strategy will, of course, be based on vigorous new efforts to promote investor awareness of these schemes, and simple but effective steps investors can take to protect themselves. We are in the midst of distributing nationwide a new brochure on the dangers of "cold-calling" practices. We are also investing considerable effort into the upcoming National Investor Education Week, which will involve town hall meetings around the country to review the basics of becoming an informed investor.

Similarly, one of the most important investor education and fraud prevention tools ever devised will soon become more widely available. Starting in about a month, the first phase of the NASD's redesigned stockbroker database will become accessible over the World Wide Web. When fully implemented by mid 1999, this service will present in a user-friendly way the disciplinary and employment background for every registered broker and every registered firm in the United States. I saw a preview two weeks ago, and I am not aware of anything remotely comparable to it for any other profession in the country. It gives every investor the power to be the first line of defense against fraud and abuse by unscrupulous brokers and disreputable firms.

These are just a few of the enforcement and investment education elements of our overall effort that have already been put in place to combat so-called micro-cap fraud. A third part of this strategy -- our regulatory approach -- is being announced this week. By proposing carefully tailored new rules and regulations and targeted modifications to existing ones, the SEC hopes to reduce the ability of scam artists to manipulate procedures that were designed to reduce burdens on small businesses and to facilitate capital formation. The changes and modifications we will be considering initially are described in the attached memorandum. We will keep you apprised as we undertake additional regulatory initiatives.

The Commission recognizes your long-standing concern and leadership in promoting the integrity of American financial markets and the protection of this nation's investors. Like you, I believe that it is critical that the SEC, other federal and state regulators, the self-regulatory organizations, and industry leaders and investor advocates, aggressively combat this egregious form of securities fraud. I look forward to working with you as we continue our effort to promote integrity and confidence in this critical area of the market.

Sincerely,



Arthur Levitt

Attachment

cc: The Honorable Thomas Bliley, Jr.
The Honorable Thomas Manton
Ms. Mary Schapiro
The Honorable Michael Oxley
The Honorable Janet Reno
Ms. Denise Voigt Crawford

MEMORANDUM

TO: **Chairman Levitt**

FROM: **William McLucas**, Director, Division of Enforcement
Lori Richards, Director, Office of Compliance, Inspections and Examinations
Nancy Smith, Director, Office of Investor Education and Assistance
Brian Lane, Director, Division of Corporation Finance
Richard Lindsey, Director, Division of Market Regulation

RE: **Status of Microcap Fraud**

DATE: **February 6, 1998**

In response to your request, we discuss below microcap fraud in the securities markets. Specifically, we address in this memorandum the extent of the microcap problem, what the SEC has done to combat it, and the SEC's future plans.

1. The Extent of the Microcap Problem

A. Definition of a Microcap Company

The term "microcap security" is not defined under the federal securities laws. Issuers of microcap securities typically are thinly capitalized and they often are not required to file periodic reports with the SEC. Securities of microcap companies may be quoted over-the-counter on the "OTC" Bulletin Board operated by the National Association of Securities Dealers, Inc., (NASD) in the Pink Sheets operated by the National Quotation Bureau, and on the Nasdaq Small Cap Market. In any of these trading mediums, public information is limited and a small number of broker-dealers controls the market.

B. Quantifying the Problem

It is impossible to quantify the exact amount of microcap fraud being perpetrated. While press accounts have reported a variety of estimates, these numbers are derived generally from anecdotal evidence and rough projections.

Our enforcement efforts clearly indicate an increase in microcap fraud involving millions of dollars of direct investor losses. These losses result from trading in companies that turn out to be worthless, and commissions and fees paid by investors to brokers peddling these securities. Furthermore, the opportunities lost by investors who could have made legitimate investments in the market are incalculable.

Two market developments have led to an increase in microcap fraud. The first is the extraordinary bull market over the last decade that has captured the public's attentions, especially over the last three years. In 1996, the Dow broke 6,000, then 7,000, and this past year broke 8,000. Daily volume on the New York Stock Exchange (NYSE) and Nasdaq is also at an all-time high, and there have been record numbers of initial public offering these past several years. The second development, not surprising given the bull market, is the record level of public participation in our securities markets. Mutual fund assets ($135 million in 1980) have grown to $3.7 trillion, surpassing the $2.6 trillion that Americans have on deposit at commercial banks. As recently as 1980, only one in 16 households invested in mutual funds; today that number is more than one in three. America has evolved from a nation of savers into a nation of investors.

C. The Type of Fraud Involved

Though we cannot quantify the amount of microcap fraud that exists, we can identify how it takes place and, therefore, can work to combat it effectively. Microcap fraud typically takes one of two forms. The first -- the "pump and dump" scheme -- often involves fraudulent sales practices, including high pressure tactics from "boiler room" operations where a small army of sales personnel cold calls potential investors using scripts to induce them to purchase "house stocks" -- stocks in which the firm makes a market or has a large inventory. Investors often receive information that, at best, is exaggerated and at worst completely fabricated. Increasingly, these stocks also are touted on the Internet by unregistered promoters. The promoters of these companies, and often company insiders, typically hold large amounts of stock and make substantial profits when the stock price rises following intense promotional efforts. Once the price rises, the promoters, insiders and brokers sell, realizing their profits. Eventually, the promoters cease their manipulative promotional efforts, the stock price plummets and innocent investors incur large losses, or lose their initial investments entirely.

Second, as part of the "pump and dump," unscrupulous brokers often employ a variety of fraudulent sales practices including "bait and switch" tactics, unauthorized trading, "no net sales" policies (where investors are discouraged or actually prevented from selling their stocks) and churning (excessive trading in their accounts in order to generate commissions for the broker). The firm often charges excessive, undisclosed markups and issues arbitrary stock quotations. Even if investors complain to the brokerage firm, it rarely disciplines its registered representative or reports the investor complaints.

2. WHAT THE SEC HAS DONE TO COMBAT MICROCAP FRAUD

The SEC has combated microcap fraud through enforcement, examinations and investor education. The details of the SEC's efforts in each of these areas are discussed below.

A. Enforcement Efforts

The SEC has dedicated an increasing amount of enforcement resources to bring actions against fraudulent microcap companies, promoters and brokers. We have moved quickly by seeking immediate relief, such as temporary restraining orders and asset freezes, and imposing strong remedies such as permanent industry bars, registration revocations and fines. To minimize investor losses in ongoing market manipulation cases, we have increased our use of trading suspensions when there is misinformation about the issuer in the market. In many cases the SEC has leveraged its resources by working closely with the criminal authorities. In the cases described below, the SEC has assigned staff to work on the parallel criminal investigations. Our close work with the criminal authorities is an essential component of our enforcement program, given that a large number of repeat violators - with little respect for civil proceedings - engage in microcap fraud.

Some of the most recent efforts by the Enforcement Division include the following:

- **December 18, 1997 – Fifty-eight individuals charged in five SEC enforcement actions:** The SEC filed five civil injunctive actions charging fifty-eight defendants with manipulation of the over-the-counter markets for microcap securities issued by Securitek International Inc., Golf Communities of America, Inc., f.k.a. Golf Ventures, Inc., Interactive Information Solutions, Inc., StockNet, Inc., International Investment Group, Ltd., Spacelex Amusement Centers International Ltd., Inc., and America's Coffee Cup., Inc.. The five actions were the result of an undercover investigation into illegal practices in the OTC securities markets conducted by the United States Attorney's Office for the Southern District of New York and the Federal Bureau of Investigation, with assistance from the SEC and the National Association of Securities Dealers Regulation. On October 16, 1996, this same undercover operation led to the arrest of forty-six individuals and the institution of administrative proceedings by the SEC against twenty-nine of the individuals arrested.

- **November 25, 1997 – Seventeen individuals indicted for stock fraud:** The SEC suspended trading in the stock of HealthTech and obtained an injunction requiring correction of the company's fraudulent financial statements. The SEC staff also worked with the United States Attorney in indicting seventeen individuals associated with the brokerage firm Meyers Pollack Robbins, Inc., including two high-level members of organized crime families, for securities fraud by the company and several brokers.

- **May 13, 1997 – Brokerage firm and principals indicted:** The SEC brought emergency administrative action against the firm A.R. Baron for fraudulent sales practices, revoked Baron's broker-dealer registration and recovered significant investor funds. The Manhattan District Attorney's Office subsequently indicted A.R. Baron and thirteen individuals associated with Baron, including the firm's principals.

- **February 1997 -- Thirty-two defendants pled guilty to criminal charges:** The Nevada United States Attorney obtained guilty pleas from thirty-two defendants on charges of racketeering, securities fraud, money laundering, illegal structuring of monetary transactions and conspiracy to commit securities fraud and wire fraud charges in connection with the sales of the stock of three microcap issuers. To date, the SEC has brought enforcement cases against a total of nineteen respondents in connection with undisclosed payments on the stocks of Enrotek Corporation, Teletek Inc., and United Payphone Services, Inc., which were involved in these criminal proceedings.

- **October/November 1996 -- Market Manipulation in Systems of Excellence, Inc.:** The SEC suspended trading and obtained a TRO and asset freeze based on a market manipulation scheme in the stock of Systems of Excellence. The scheme which involved the misuse of Form S-8, included bribes paid to newsletter writers to promote and disseminate misleading information about the company over the Internet. Five individuals have plead guilty to related criminal charges.

- **February 1996 -- Abuses of Regulation S:** The SEC instituted and settled proceedings against Candie's Inc., Salvatore Mazzeo and others based on their use of Regulation S in a scheme to evade the registration requirements of the securities laws.

In addition, the SEC is cracking down on individual brokers who engage in fraudulent practices which impact the microcap market. For instance, in November 1995 and May 1997, the SEC and the Department of Justice filed charges against twenty-eight rogue brokers throughout the country for engaging in a wide range of fraudulent conduct, including forging investor checks, engaging in unauthorized transfers of client funds, selling securities of nonexistent companies and creating false account statements.

The SEC's Enforcement Division has dedicated certain staff almost exclusively to coordinating its nationwide enforcement effort to address microcap issues. The goals of this group are to: intervene in microcap frauds at the earliest point possible to minimize investor harm; to enhance surveillance and coordination with the SEC's operating divisions as well as the NASD; and to coordinate a nationwide approach to microcap fraud with other state, federal and industry regulators.

In addition, the Enforcement Division is addressing the new technology through which frauds are being committed by dedicating resources to combat fraud on the Internet. To that end, the SEC's Division of Enforcement, with the assistance of other SEC staff, has assembled a group of professionals to conduct Internet surveillance. These professionals use the latest browsing software to monitor the Internet, including message areas such as newsgroups and bulletin boards.

B. Examination and Inspection Efforts

On the examination front, the SEC's broker-dealer examination program in the Office of Compliance Inspections and Examinations (OCIE) has prioritized the review of firms that specialize in underwriting, marketing, or retailing microcap stocks. The examination program operates as the SEC's "eyes and ears," uncovering the latest techniques used by broker-dealers, salespersons, and issuers to skirt the federal securities laws and defraud investors. These examinations frequently yield leads for investigations by the SEC's enforcement staff and the SROs.

In all areas of the country, particularly in New York, South Florida, and the Colorado/Utah area, examiners are targeting broker-dealers that have been the subject of customer complaints, have prior disciplinary actions against the firms or their principals that specialize in selling microcap stocks to retail investors, or are for other reasons believed to be engaging in microcap fraud. SEC examiners also are scrutinizing the records of microcap issuers maintained by registered transfer agents to detect irregularities in the issuance and transfer of shares which typically accompany frauds.

For example, examiners recently initiated an examination sweep of several firms that are players in the microcap market. The firms targeted for these examinations have many of the "red flags" of fraudulent microcap activity, such as customer complaints, significant profits from underwriting and subsequent aggressive market making of illiquid microcap securities, and large pools of inexperienced cold callers. Examiners arrived at the firms unannounced, and interviewed the firms' principals, registered representatives, sales assistants, and compliance staff. Examiners toured the premises including the "bull pens" or sales "pits" where cold callers make hundreds of telephone calls trying to sell securities to the public.

In these and in other examinations, we have made a number of observations about microcap firms. For example, while the supervisors of many firms state that their employees do not use sales scripts in making cold calls to the public, examiners often found a number of scripts on the desks of cold callers. In addition, it appears that most of the firms we examined only minimally supervise and train their armies of cold callers. Some supervisors merely walk through the sales pits, overhearing the sales pitches and randomly intercepting telephone conversations, and only reacting to problems disclosed in customer complaints. Many firms also claim they do not sponsor sales contests, though conversations with registered representatives in the bull pens revealed evidence of contests for the number of new accounts opened by cold callers.

Examiners are now hard at work analyzing hundreds of documents, such as trading records, commission payouts, and customer complaints, to reconstruct weeks of trading and conversations with customers. They will use these documents to determine if any of the firms engaged in the hallmark practices of microcap fraud: unauthorized trading or unsuitable bait and switch sales, refusal to sell securities when asked to do so by customers, exaggerated or fraudulent claims to potential customers to induce them to buy securities, manipulation of the market for securities, or working for or in cooperation with individuals who have been barred from the industry or known to be under

investigation for securities violations. Any evidence of abuse will be referred to the SEC's Division of Enforcement staff for further investigation and enforcement action.

The SEC also is coordinating its efforts to curb abuses in the microcap market with the SROs, including the NASD by focusing on the quality of supervision and on rogue brokers.. For instance, in 1994, the SEC staff with the NYSE and NASD conducted a review of the hiring, retention and supervisory practices of nine of the largest brokerage firms. Two years later, the SEC, together with the NASD, NYSE and the North American Securities Administrators Association, Inc. (NASAA) conducted a joint examination sweep to review the sales practices of selected registered representatives employed by small and medium-sized firms as well as the hiring, retention and supervisory practices of the brokerage firms that employ them. The sweep revealed that some firms employ registered representatives with a history of disciplinary actions and customer complaints, use only minimal hiring procedures, and have supervisors in branch offices who fail to review customer transactions adequately to detect sales abuses. The sweep also revealed that almost one-half of the branches that engage in cold calling were violating federal cold-calling rules.

As a result of that sweep, the SEC, NYSE, NASD and NASAA prepared a public report making specific recommendations designed to correct these problems. For example, the report recommends that brokerage firms institute more stringent hiring procedures for registered representatives; heighten supervision of registered representatives with a history of customer complaints, disciplinary actions or arbitrations; and train and supervise cold-callers. Finally, as part of its effort to combat microcap fraud, the SEC's examination staff is working with the SROs and the states to develop a training conference for securities examiners focused on the early detection of microcap fraud.

C. The SEC's Efforts to Combat Microcap Fraud Through Investor Education

Since an educated investor provides the best defense against securities fraud and often gives us the first warning of wrongdoing, the SEC's Office of Investor Education and Assistance (OIEA) educates investors on how to identify securities fraud and urges investors to report suspicious activity to securities regulators.

We urge investors to complain to us promptly. In 1997, we received nearly 18,000 complaints. Our database of complaint information tracks breaking trends, allowing us to identify problem brokers, firms, and financial products. The intelligence we gather from complaints helps to direct our examination and enforcement resources to the areas of greatest need first. The SEC has made it easier for investors to complaint over the Internet by creating the on-line Division of Enforcement Complaint Center at www.sec.gov/enforce/comctr.htm. The on-line complaint center presently receives over 100 complaints a day.

The SEC's efforts to reach out to investors include the following measures:

- **Publications**

Since 1994, OIEA has written and distributed over a dozen pamphlets and brochures that warn investors about scams and state in plain English what every investor should know about investing. All of these publications are available, free of charge, on the SEC's Website (http:\\www.sec.gov/invkhome.htm) and through the SEC's toll-free publications and information line (1-800-SEC-0330).

OIEA's newest publication, entitled Cold Calling Alert, specifically addresses problems in the microcap market. It tells investors what the cold-calling rules are, how to deal with cold calls, how to stop them, and how to evaluate investment opportunities that come over the telephone.

- **Investors' Town Meetings and Seminars**

To meet investors and listen to their concerns, in 1994 the SEC began to organize Investors' Town Meetings throughout the country. To date, Chairman Levitt has spoken at 22 town meetings. These events attract between 800 and 1200 investors and result in media coverage that reaches millions more. At each meeting, Chairman Levitt discusses questions investors should ask before they invest. Seminars follow the town meetings so investors can learn more about specific topics of interest.

In December 1997, the SEC announced an unprecedented national public awareness campaign about the importance of saving, investing, and avoiding securities fraud. The SEC, the North American Securities Administrators Association, and the Council of Securities Regulators of the Americas will launch the "Facts on Saving and Investing Campaign" throughout the Western hemisphere beginning on March 29, 1998. This educational campaign will include a wide range of simultaneous events throughout the Americas, including town meetings, school programs, and other educational activities in the United States. As planning progresses, a web site will be created to provide up-to-date information about the campaign.

3. FUTURE PLANS TO COMBAT PROBLEMS OF MICROCAP FRAUD

The SEC is also committed to reviewing and, if appropriate, revising the rules and regulations affecting the microcap market. The goal of our review is to close loopholes in existing rules and regulations which may be facilitating microcap fraud, and then, if needed, to develop new rules which will make such fraud less likely to occur in the first place.

In September 1997, the SEC formed a working group on microcap fraud to bring together top officials from the SEC's Divisions of Enforcement, Corporation Finance, and Market Regulation, as well as from the Office of Compliance Inspections and Examinations, the Office of General Counsel, and the Office of Investor Education and Assistance. The working group provides a forum where abuses uncovered by the enforcement and examination staffs and customer complaints can be

addressed by the SEC staff who write the rules for stock markets, for brokers and for raising capital. The working group has been meeting -- and will continue to meet -- regularly to exchange ideas and identify better ways to attack the current problems in the microcap market.

To date, the working group has focused on possible changes to the rules governing market-makers and clearing brokers and has begun to examine the costs and benefits of current capital formation rules. The working group also has been exploring how best to devise an early warning system for detecting fraud and how to use the SEC's enforcement resources most effectively to fight fraudulent practices in the microcap market. In addition, the working group is working with other regulators, such as the NASD and the states, and with the criminal authorities in sharing intelligence and devising creative and coordinated solutions to microcap fraud.

As a result of the efforts begun by the working group, several proposed rule/regulation changes already have been proposed by the SEC staff and will be considered by the SEC at an open meeting on February 10, 1998.

A. Rule and Regulations Changes to Be Considered on February 10, 1998

- **Exchange Act Rule 15c2-11 Governing Initiating and Resuming Quotations**

Rule 15c2-11 is intended to deter the publication of stock quotations in the OTC Bulletin Board, the Pink Sheets and similar media that may be used in fraudulent schemes. Before publishing the initial quotation for a particular stock, or after a trading halt, the current Rule requires brokers to review such information as the issuer's most recent balance sheet, profit and loss, and retained earnings statements; the nature of the issuer's business; the nature of the products or services offered; the nature and extent of the issuer's facilities; and any relationship between the broker-dealer and company insiders. As a result of the recent rise in microcap fraud, the SEC's staff recommended amendments to the Rule that would place greater information review requirements, and thus accountability, on broker-dealers publishing quotations for securities in a quotation medium other than a national securities exchange or Nasdaq and would provide greater investor access to information about those securities. Among other things, the proposals would: eliminate the Rule's "piggyback" provision, which currently permits broker-dealers (other than the initial broker-dealer) to quote the security without having current issuer information; require broker-dealers that publish priced quotations for a security to obtain and review updated information about the issuer at least annually; expand the information required about issuers that do not file periodic reports with the SEC; and, require documentation of the broker-dealer's compliance with the Rule. These amendments will be considered by the SEC on February 10, 1998.

- **Regulation S**

Regulation S provides a safe harbor from registration for certain off-shore offerings. The SEC has found that some issuers have used Regulation S as a means of indirectly distributing securities into the markets without registration. In light of these problems, in February 1997, the SEC proposed

amendments to Regulations S to prevent such unregistered distributions of the securities in the United States markets. On February 10, 1998, the SEC will be voting on the proposed final rule on this issue which would require, among other things, that: 1) equity securities placed offshore by domestic issuers under Regulations S be classified as "restricted securities" within the meaning of Rule 144, so that resales without registration are restricted; 2) the period during which issuers must comply with the Rule's offering restrictions be lengthened from 40 days to one year; and 3) certification, legending and other requirements, which currently are only applicable to sales of equity securities by non-reporting issuers, be imposed on these equity securities.

- **Form S-8**

Form S-8 is a short form that public companies may use to register sales of stock to their employees, consultants, and advisors as part of their compensation. These registration statements become effective automatically without SEC review. The staff has seen Form S-8 used improperly in connection with capital raising, either by using the shares to pay broker-dealers or other consultants that assist in capital raising or by using employees or "consultants" as intermediaries to raise capital indirectly.

On February 10, 1998, the SEC is considering, among other things, proposed changes to Form S-8 which would: 1) make Form S-8 unavailable for sales to consultants and advisors who directly or indirectly promote or maintain a market for the company's securities; and 2) require disclosure in Part II of Form S-8 of the names of any consultants or advisors to whom the registrant will issue securities under the registration statement as well as the amount and the nature of the consultant or advisory services.

B. Rule Changes to be Considered After February 10, 1998

Other rules which the SEC may review and consider in the future include the following:

- **The Penny Stock Rules**

Currently, the definition of "penny stock" excludes securities that, among other things, are priced at $5 or more per share. The SEC staff believes that the penny stock rules are very effective. However, some broker-dealers have circumvented their application by pricing securities above the current $5 threshold. The staff is considering a recommendation to raise the price threshold in conjunction with other possible changes to the penny stock rules to cover more of the types of securities that are used in microcap frauds. In evaluating this and other options, the SEC will carefully consider whether the proposed changes will be effective in curbing abuses, and not unduly interfere with the ability of legitimate smaller issuers to raise capital and compete with more established companies.

- **Rule 504 of Regulation D**

Rule 504 of Regulation D allows companies to raise up to $1 million per year in seed capital without complying with the registration requirements of the federal securities laws. In 1992, the SEC amended Rule 504 to eliminate the federal limitations on these offerings other than the general antifraud provisions and the requirement to file a notice with the SEC 15 days after the first sale. The staff is revisiting Rule 504 to determine whether changes need to be made. The staff will consider: 1) whether the exemption should be conditioned on state registration of the offering; and 2) whether the securities sold in certain exempt state offerings should be restricted. In reviewing this issue, the staff will be careful to: 1) balance the need of legitimate small businesses to raise capital efficiently with the continuing presence of fraud in the secondary markets; and 2) avoid imposing federal regulations that unnecessarily overlap state regulation of offerings.

- **NASD and NYSE Rules for Clearing Brokers**

The SEC published for public comments a rule proposal from the NASD (and a similar one from the NYSE) regarding the scope of a clearing broker's responsibility when it receives notice that an introducing broker may be engaged in fraudulent sales practices. Among other things, the proposed rule requires that clearing firms promptly forward to introducing firms and to the introducing firms' SROs any written customer complaints about the introducing firm. The comment period on the NASD's rule proposal has expired, and the NASD is considering whether to amend its proposed rule based on the comments received from the public. The Commission staff also is working with representatives from the industry, the SROs and the states to ensure that information from clearing firms about "red flags" at introducing firms is shared effectively with regulators.

- **Bulletin Board Standards**

Members of the SEC's working group on microcap fraud and the SEC's Division of Market Regulation have met with the NASD to discuss tightening regulations that govern the Bulletin Board. The NASD is now seeking comments from its membership on several microcap fraud initiates and ultimately will be sending the proposals to the SEC for its consideration.

NASD REGULATION
An NASD Company

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January 23, 1998

Honorable John D. Dingell
Ranking Member
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Room 2125 Rayburn House Office Building
Washington, D.C. 20515-6115

Dear Congressman Dingell:

This letter is in response to your December 12 letter regarding the December 15 *Business Week* article titled "Ripoff! The Secret World of Chop Stocks — and How Small Investors Are Getting Fleeced." It provides the report you requested on the extent of this problem, what we have done, and what we plan to do in the future to address it.

First, as you note in your letter to us, we would like to underscore that the overwhelming majority of firms in the industry are reputable. The problems chronicled in the article are rare, and the coordinated efforts of securities regulators seek to make them even more unlikely.

With regard to the specific allegations reported in the *Business Week* article, — as with all allegations of wrongdoing — the NASD aggressively investigates charges of manipulation, fraud, and bribery in the nation's securities markets. Regulators and law enforcement officials are working together to assure that the securities markets are safe for investors. Comment in this letter on the progress of specific non-public, ongoing investigations, or efforts to address misconduct in a specific area of the market, while underway, would be inappropriate and would jeopardize our actions against wrongdoers. If you require such information regarding open investigations, we will provide you and your staff a confidential briefing. We are able to comment publicly on several aspects of the article, however.

We believe that the article does not fairly describe NASD's accomplishments in cleaning up illegal activity in low-priced securities. With regard to the firms that were referenced in the *Business Week* article, we can report that seven of them are no longer in business, and the NASD played an important role in most of those firms' demise. For example, Stratton Oakmont and Euro-Atlantic were expelled as a result of NASD Regulation disciplinary actions. Another firm, A.R. Baron, was indicted by the Manhattan District Attorney's office for, among other things, grand larceny and enterprise corruption. NASDR played an important role in developing this case, as reflected in the DA's press release announcing the indictments.

The article acknowledges that two of the individuals it mentions, Meyer Blinder and Robert Brennan, have long ceased any registration with a member firm. The NASD brought the first significant cases against the firms through which Blinder (Blinder Robinson) and Brennan (First Jersey and Hibbard Brown) operated. An NASD decision subsequently expelled Hibbard Brown.

The article also states that Meyers Pollock Robbins was a "160-broker national firm that had escaped attention until the Nov. 25 indictments." However, Meyers Pollock had indeed attracted attention from regulators. NASDR has two outstanding complaints against the firm (issued in August 1996) alleging that the firm and several of its representatives defrauded customers by making untrue statements to customers and sold securities when no registration statement had been filed. The second complaint alleges that the firm effected transactions as principal at prices that were not fair. Furthermore, in March of last year, the SEC filed a lawsuit in federal court alleging violations of the antifraud and registration provisions of the federal securities laws in the offering of $13.9 million in debt securities by the firm and its president, Michael Ploshnick, among others. The SEC acknowledged the assistance of the NASD in conducting the investigation that led to this action.

The article also notes that on November 13, 1997, "the U.S. Attorney in Brooklyn charged 13 people — brokers, Mob associates, and officials of two brokerage firms — with manipulation the prices of thinly traded micro-cap stocks." The action involved Hampton Securities, a firm that NASDR had expelled weeks prior to the indictment for denying our examiners access to their offices. Our continuing cooperation with the US Attorney on this matter was noted in the announcement of the indictment.

Finally, the allegation in the article by an anonymous "chop house executive" of bribery of an NASD examiner is extremely serious. The NASD has no knowledge of such an event. Despite repeated requests, *Business Week* has

been unable to disclose the identity of the accused person. We made a formal written request for the information underlying this accusation by a questionable anonymous source on December 5, 1997, and on December 10 we were informed by the McGraw-Hill Companies that "*Business Week* does not know and has never been advised of the identity of the NASD employee referenced at pages 114 and 118."

While much needs to be done — unfortunately, securities fraud has yet to be eliminated — we provide below a description of our efforts to date in combating microcap fraud and our plans for the future.

The Over-The-Counter Market

Before we address the questions posed by your letter, I believe it would be useful to describe the environment in which many of these "chop stocks" exist. The NASD has certain regulatory responsibilities that extend beyond The Nasdaq Stock Market to what is known as the OTC or over-the-counter market. The over-the-counter market is a vast amalgam of publicly traded companies that list neither on Nasdaq nor on any exchange. Contrary to a popular misconception, often perpetuated by unscrupulous operators, the over-the-counter market is not Nasdaq. The two are separate and distinct. It is in the thinly traded, microcap securities that characterize the over-the-counter-market where we find greatest potential for fraudulent activity.

There are several reasons for this. First, thinly traded stocks typically have a small market capitalization. Accordingly, they are more easily subjected to manipulative practices by unscrupulous brokers, issuers, and promoters. Second, a significant number of OTC companies report absolutely no information to the SEC, making their financial situation a virtual blank slate to investors. While some of these companies make financial information available, what reaches investors is not required to be subject to accounting auditing standards. Third, there is no minimum price that an OTC company must maintain to trade. Stocks in the OTC market can and do trade for mere pennies.

A part of the over-the-counter market is what is known as "The OTC Bulletin Board." While it is a system operated by Nasdaq, the Bulletin Board is markedly different and separate and distinct from The Nasdaq Stock Market. It is an electronic quotation service for subscribing members. While the system displays real-time quotes, last sale prices, and volume information in domestic securities, there is no formal legal relationship between the OTC issuers whose shares are quoted there and Nasdaq. The companies need not meet any listing standards to have their stock included in the Bulletin Board. There are no periodic

reporting requirements for continued inclusion in the service; only limited phone, contact, and address information is available in the OTC Bulletin Board company listings. This system provides a centralized and automated alternative to the Pink Sheets, which historically have been published on paper once each day, but which are now available electronically via market data vendors.

A misperception that is frequently fostered by scam artists is that trading on the OTC Bulletin Board is akin to trading in a highly regulated market such as Nasdaq. They will often refer to an OTC stock as listing on "Nasdaq's OTC Bulletin Board" or on "the Nasdaq OTC" or some other deliberately confusing variation that improperly links the two. We have proposed important new rules that will change the nature of the issuers quoted on the OTC Bulletin Board and the way our members can sell OTC securities to the public. I will discuss these proposals in detail later in my letter.

The Extent of the Problem

You have asked us for our estimates of the extent of the problems that exist in this area. Unfortunately, we are unaware of any reliable estimates of the magnitude of the problems described in the *Business Week* article. This lack of information on the extent of violative conduct is to be expected, since those who would break the law take great pains to conceal their efforts. We believe that reliable estimates of this type would be difficult to make with any degree of statistical rigor, and we do not believe that they would add significantly to more precisely targeting our antifraud resources.

There is a number often referenced by the press of $6 billion of fraud annually in the microcap market. SEC Chairman Arthur Levitt was asked about that estimate during his September 22, 1997 testimony before the Senate Permanent Investigations Subcommittee's hearings on microcap fraud. He stated that the number was most likely based on a study done a number of years ago by state regulators and then, assuming that fraud growth paralleled market growth, multiplied the original estimate by market growth since that time. While he stated that his anecdotal experience tells him that there is no question that fraud will increase with market increases, he said that he has not yet seen a study of the area that he would call reliable. As stated above, estimates of fraud are difficult to make with sufficient rigor to result in reliable findings, and we would thus also question the accuracy of the $6 billion estimate.

The Bureau of Justice Statistics could provide further information on the methods, cost, and reliability involved in compiling such statistics. That being said, we do believe that the "chop stock" problem described in the *Business Week*

article is confined to a very small percentage of both our 5,500 members and their half million registered persons.

NASDR's Record

We believe as regulators that we must redouble our efforts in the microcap area. NASDR has already begun to do so. In 1996, we significantly increased the number of staff dedicated to regulation and enforcement by adding more than 150 new positions. By the year 2000, NASDR plans to spend more than $100 million to enhance its systems for market surveillance and increase examination, surveillance, enforcement, and internal audit staff.

We have begun to see the fruits of our investment. In 1997, the NASD resolved 1,211 formal disciplinary actions, an increase of more than 15 percent from the prior year. New disciplinary actions filed and settlements authorized declined from a record 1,200 in 1996 to 895 last year, reflecting in part a greater emphasis on pursuing significant, complex fraudulent conduct in the microcap market. The number of individuals barred or suspended in 1997 reached 664, an increase of more than 10 percent from 1996. Disciplinary fines collected totaled a record $9.99 million in 1997, representing an increase of almost 30 percent over 1996.

Enforcement Cases

In our focus on the microcap market, we have brought many significant cases in recent years that address the abuses reported in the *Business Week* article, including:

Stratton Oakmont — In December 1996, NASDR expelled Stratton Oakmont and barred its president and its head trader from the securities industry. The respondents have appealed the case to the SEC. This case imposed restitution and fines in excess of $1 million. Another complaint was filed last year against Stratton Oakmont and others alleging that the firm made approximately $28 million in illegal profits during the first day of aftermarket trading of five small stock offerings.

In addition, on October 16, 1997, NASDR filed a detailed complaint against 33 former principals and brokers of Stratton Oakmont. The complaint identifies at least 70 specific customers who were victimized by these brokers. While these cases take considerable time to develop, NASDR believes it is critical to not only rid the securities industry of miscreant firms and their principals but to specifically

target the individual registered representatives who directly committed these violations.

Sterling Foster — In October 1996, NASDR charged Sterling Foster & Company of Melville, New York, and 15 of its executives with defrauding customers of $53 million in three 1995 initial public offerings ("IPOs").

According to the complaint, Sterling Foster agreed, before an IPO, to buy for $2 a share the stock that insiders of the company had bought for pennies, ensuring the insiders an immediate profit. The firm would then promote the IPOs to its customers using boiler room sales practices, omitting important information and making false statements about the prospects for the company. These sales efforts resulted in enormous demand for the shares among Sterling Foster's customers, allowing the firm to sell to its customers about twice as many shares as it had sold them in the initial offerings.

The NASD's action against the firm and its principals has been stayed by a federal court pending the outcome of an ongoing criminal investigation by the U.S. Attorney's Office for the Southern District of New York. The portion of the case related to the firm's compliance officer and 10 of its registered representatives is in the final hearing stage. NASDR has worked extensively with the FBI in their criminal investigation of Sterling Foster. That investigation has resulted to date in guilty pleas by the firm's director of corporate finance and by an involved outside selling security holder.

Hibbard Brown — Working with the New Jersey Bureau of Securities, the NASD reviewed over 6,000 trades in a shell company named Site-Based Media and uncovered fraudulent activity by the Hibbard Brown firm that generated $8.7 million in illicit profits in just eight days.

Hibbard and its sole owner Richard Brown were subsequently expelled by the NASD and ordered to pay $8.7 million back to retail customers. Additionally, the firm's head trader and Brown were barred and fined. We continue to discipline former Hibbard employees for their conduct with the firm. To date, 13 branch office managers and registered representatives have been barred for their abusive sales practice activities.

A.R. Baron — In May 1997, the Manhattan District Attorney announced the indictment of A.R. Baron & Co., Inc. and the arrest of 13 individuals for cheating thousands of investors out of more than $75 million. The individuals and the firm, which is now defunct, were charged with participating in a pattern of criminal activity. Included in that pattern were lying to investors to induce them to buy

certain low-priced securities; manipulating the markets in certain microcap stocks to benefit themselves and their favored customers; making unauthorized trades in the millions of dollars; refusing to honor its customers' directives to sell securities in their accounts; outright thefts from investors; and forging documents to prevent detection of their crimes. Four NASDR examiners from our Chicago office worked closely with the Manhattan District Attorney throughout this important investigation.

NASDR has brought its own cases against A.R. Baron, its principals and registered representatives. In one of those actions, the firm paid more than $1.5 million in restitution to customers and fines for charging fraudulently excessive markups in more than 200 separate transactions.

D.H. Blair — In August 1997, D.H. Blair & Co. Inc. was fined $2 million for overcharging its customers and for engaging in fraudulent pricing activity. Blair will repay an additional $2.4 million to investors who were overcharged as the result of fraudulent and excessive mark-ups in 16 securities. D.H. Blair's chief executive officer and head trader were also fined a combined $525,000. More than 3,100 retail customers from 43 states will receive restitution payments.

The firm charged excessive markups in 16 Nasdaq SmallCap securities whose IPOs were underwritten by D.H. Blair Investment Banking Corp. NASDR found mark-ups greater than 10 percent (a level considered fraudulent) in 14 of the 16 securities that D.H. Blair Investment Banking Corporation had underwritten. D.H. Blair placed virtually all of the offerings with its own customers and controlled the after-market trading in all 16 securities, in some cases for up to four and a half months after the IPO effective date.

As part of the settlement, D.H. Blair is also required to hire an independent consultant to review and monitor the firm's trading, sales, supervision, and other compliance-related policies and practices for two years. This consultant will also recommend necessary improvements, which the firm must implement.

H.J. Meyers & Company — On January 12, 1997, NASDR suspended, fined, and censured 15 current and former managers and registered representatives at H.J. Meyers & Co., Inc. for charging retail customers unfair prices or for failing to prevent that activity.

NASDR found that the salesmen were responsible for their customers being overcharged. In every case, the salesmen received gross commissions in excess of 10 percent for the sale of the common stock and warrants of Xerographic Laser

Images Corp. and Integrated Security Systems, Inc., securities the firm dominated and controlled.

The actions arose from NASDR's investigation into pricing practices at H.J. Meyers. On July 25, 1996, NASDR sanctioned 22 of the firm's managers and sales representatives, and ordered the firm to pay more than $1 million in restitution and interest to more than 3,000 customers who were charged unfair prices in seven securities H.J. Meyers traded between 1990 and 1993. The firm also paid a fine of $250,000.

With the second action, a total of 37 brokers have been sanctioned, and more than $1.5 million in fines and restitution have been assessed in the H.J. Meyers investigation.

GKN Securities — On August 14,1997, GKN Securities Corp., as well as 29 brokers and supervisors, were fined $725,000 by NASDR and, in addition, will repay more than $1.4 million to investors who were overcharged as the result of a two year-long program of excessive mark-ups in eight securities. Nearly 1,300 investors from 39 states and the District of Columbia and Puerto Rico will receive payments from GKN. Three of the firm's top executives received significant fines and suspensions. All of the violations occurred at GKN's offices in New York City, Stamford, Connecticut, and Boca Raton, Florida.

From December 1993 through April 1996, GKN dominated and controlled the immediate after-market trading in eight securities it underwrote so that there was no competitive market for them. As a result, GKN was able to charge excessive markups ranging from six percent to as much as 67 percent over the prevailing market price in more than 1,500 transactions. At least 90 percent of these transactions were fraudulent because the mark-up exceeded 10 percent.

As part of the settlement, GKN must pay a $250,000 fine to NASDR, and hire an independent consultant to review the firm's trading policies and procedures for 18 months. This consultant will also recommend necessary improvements, which the firm must implement. Further, GKN is required to disclose to customers on their confirmation slips whenever a broker's compensation exceeds ten percent of the gross transaction amount.

La Jolla Securities — On September 11, 1997, a NASDR District Committee ordered that San Diego-based La Jolla Capital Corp. be permanently barred from selling penny stocks and that five of its senior officials be sanctioned for circumventing the penny stock rules, and ordered fines and restitution of more than

$950,000. Penny stocks are unlisted securities that trade over-the-counter and are priced under $5 per share.

La Jolla Capital and its President Harold B.J. Gallison were fined more than $400,000 and are jointly responsible for repaying more than 100 investors from 26 states, the District of Columbia, and British Columbia almost $400,000. The remaining four senior officials were fined a total of more than $150,000.

NASDR found that, from January 1994 through May 1995, La Jolla Capital and certain senior officials circumvented investor protection laws in approximately 140 transactions involving 15 separate securities. All of the transactions involve penny stocks. The violations occurred at La Jolla Capital's offices in San Diego, New York, Las Vegas, Bethesda, Maryland, and Modesto, California.

NASDR found that La Jolla Capital designed a system to circumvent the SEC's strict penny stock rules that ensure that investors receive honest and candid information about risk disclosure and suitability issues before they invest. La Jolla Capital had investors sign a misleading document that purported to exempt the transactions from the penny stock rule requirements. The letters were portrayed to investors as a "formality," and in some cases investors' signatures were forged. La Jolla also was found to have implemented misleading and deficient supervisory policies and procedures designed to foster the improper claim of this exemption.

Between February 1996 and October 1996, 22 other La Jolla Capital brokers and supervisors were fined and disciplined in connection with this case. The case is on appeal to NASDRs National Adjudicatory Council.

HGI and Maidstone Financial — On December 22, 1997, NASDR issued a complaint against HGI, Inc., formerly known as The Harriman Group, Inc., Maidstone Financial, Inc., and four principals of the two firms alleging fraud in connection with three public offerings. The alleged fraudulent activities resulted in more than $16.2 million in illegal profits and defrauded scores of investors in the process.

According to the complaint, the two firms, working through the four individuals, illegally profited by purchasing stock at below market prices to cover large short positions each firm had intentionally created in their inventories. In each offering, the firms purchased the covering shares from shareholders that had received their securities prior to the initial public offerings through private placements and bridge financing arrangements. In registration statements and amendments filed by the two firms with the SEC, the shares of these "selling shareholders" were restricted

and therefore could not be sold for up to two years after the IPO, unless the lead underwriter granted permission.

Both firms entered into private transactions with the "selling shareholders" to purchase their shares to cover the short positions in their inventories. The firms' undisclosed distribution of these securities violates federal securities laws and NASD rules.

As alleged, the two firms, acting through the four principals, engaged in fraud by failing to disclose the private transactions with the selling shareholders, the firms' plans to distribute the selling shareholders' securities to the public, and the receipt of unlawful underwriting compensation.

Neither firm currently operates a securities business. In June 1997, HGI, which was based in Jericho, N.Y., filed to withdraw its membership from the NASD. In early December 1997, Maidstone, which was based in Manhattan, also filed to withdraw from the NASD.

Monroe Parker Securities — NASDR issued a complaint on December 23, 1997, charging Monroe Parker Securities, Inc., its vice president Bryan Herman, and its head trader Ralph Angeline with price manipulation and excessive markups in the trading of Steven Madden, Ltd. Warrants, alleging illicit profits of $4.4 million.

During late 1994 and early 1995, Monroe Parker, acting through its vice president and head trader, acquired 94 percent of the Steven Madden warrants available for public trading. The significant majority of these warrants were acquired from Stratton Oakmont Securities, Inc.—Herman's and President Alan Lipsky's former employer. After acquiring this dominant position, Monroe Parker allegedly manipulated the warrants' price and, within six days, sold its entire inventory to its retail customers at fraudulently excessive markups.

We allege that more than $3 million in profits were made from these fraudulent trades—more than $2 million were made by the firm, while Herman and Lipsky personally profited by an additional $1.1 million. Once these profits were made, Monroe Parker no longer had an interest in artificially supporting the price, and reduced its bid for the security. Within a week, the price of the warrants fell from $3.625 to $1.50 and its customers lost millions of dollars.

The complaint also charges Monroe Parker, Herman, and Lipsky with fraud in the sale of a second security, United Leisure common stock. As alleged in the complaint, customers who purchased United Leisure stock, upon the firm's recommendation, were not told that the stock came from the personal accounts of Herman and Lipsky (who were previously given the stock at no cost by Monroe

Parker). Herman and Lipsky personally profited by more than $1.3 million in these transactions.

Monitor Investment Group — On January 21, 1998, NASDR issued a complaint against Monitor Investment Group and 17 of its principals and brokers. The complaint charged fraud in connection with the sale of common shares of an OTC Bulletin Board security that resulted in more than $600,000 in illegal profits. Monitor, which was headquartered in New York City, withdrew its membership from the NASD in October 1996.

In addition to the firm, the complaint names Monitor's owner and Chief Executive Officer, its President, and its Compliance Director. Also named are Jeffrey Pokross and Salvatore Piazza who are believed to have secretly controlled Monitor by participating in the day-to-day operations of the firm, infusing capital into the firm, directing brokers' activities, and bringing investment banking transactions to the firm.

The complaint alleges that Monitor—acting through Palla, Piazza and Pokross — manipulated the price of the security and exploited its position as the stock's only market maker to illegally raise the per share price from $1 to $6 3/4 over a two-hour period. From its sales of previously acquired stock, Monitor, its principals, and others are alleged to have illegally profited by more than $600,000 in two days.

NASDR also alleges that Monitor used concerted and high-pressure sales tactics to sell a large volume of the Bulletin Board company's shares during the two-day period, including false and deceptive sales pitches and ignoring the suitability of the stock, a speculative and low-priced security with a history of operating losses, when selling it.

The complaint states that Monitor brokers were told that they would receive compensation of up to 33 percent of the sales proceeds, which would not be disclosed to investors. Customers were charged undisclosed mark-ups of at least 14 to 33 percent. NASDR generally considers mark-ups in excess of 10 percent to be fraudulent.

The complaint also states that Monitor permitted at least one unregistered individual to act as a broker. The firm is charged with lying to regulators about the use of unregistered personnel and using fictitious records to conceal their misconduct. NASD supervision rules were also allegedly violated when the firms did not have supervisory systems and procedures that would have prevented the violations.

Test Cheaters — Finally, every investor has the right to expect that his or her broker is honest and understands the securities markets and its regulations. This is a cornerstone of investor protection. To fulfill this responsibility, NASDR in August 1997, announced that it had barred, censured, and fined 20 more registered representatives suspected of paying an impostor to take a qualification exam on their behalf. More than $1.8 million in fines and forfeited commissions were assessed against these brokers. This brings to 41 the number of suspected "test cheaters" we have thrown out of the industry. NASDR has also worked closely with the Manhattan District Attorney's office in the indictments of 52 impostors and others implicated in this matter.

Recent NASD Rules and Rule Proposals

NASDR combats fraud in the microcap market not only with enforcement actions directed at specific firms and registered reps, but through effective rules as well. These rules apply to all of our members and all of their associated persons.

Clearing Firms

We have been active in enhancing the role of clearing firms in the regulation of thinly capitalized introducing firms. We are working hand in hand with both the SEC and the New York Stock Exchange to impose, through across-the-board rulemaking, new reporting responsibilities on firms that act as clearing brokers for other firms. These proposals would require clearing firms to provide information that will allow self-regulators to better monitor the activities of the firms on whose behalf they clear trades -- so called "introducing firms." Under proposals that that were approved by the NASD Board of Governors in September 1997, clearing firms will be required to report to the NASD or other Designated Examining Authority certain written complaints that they receive on activities of the introducing firm, and forward all complaints received to the introducing firm. The clearing firm will also be required to make available to its introducing firms reports and analyses of the introducing firm's own activities. That proposal has been filed for approval with the SEC and, at the same time published for comment in NASD *Notice to Members 97-79*.

Taping Rule

When we succeed in putting a recidivist firm out of business, our job is not over. Sometimes the principals in those firms turn around and form new firms under a different name; other times the brokers go in clusters to existing broker-dealers. When a large number of these brokers become employed at another broker-dealer, this raises the risk that their new firm will have significant sales

staff who may not have yet forgotten their bad habits. In September 1997, NASDR filed with the SEC a significant proposal on the taping of broker's conversations with their customers. Our new rule will require a brokerage firm to tape record all brokers calls with existing or potential customers if a certain percentage of the firm's brokers were employed by a disciplined brokerage within the last two years. The taping rule defines a disciplined firm as one that has been expelled from a securities industry self-regulatory organization, or has had its registration revoked by the SEC, for sales practice violations or telemarketing abuses. The threshold percentage of brokers from a disciplined firm that would require recording will vary from 40% for a small firm to 20% for a large firm.

Telemarketing

We have seen too many instances where investors become the unwitting victims of "cold calls" and high-pressure sales tactics. These tactics are used by certain brokers to convince an investor to purchase stock over the telephone from a broker they do not know. NASDR has responded to abuses of this type by adopting "telemarketing rules." In 1995, we adopted a "cold call" rule that requires NASD member firms to keep "do not call" lists of persons who do not wish to receive telephone solicitations from the securities firm or its brokers. More recently, we have strengthened the regulation of this area by prohibiting firms and their brokers from telephoning a noncustomer's residence to sell securities during certain times, unless they have the prior consent of the person. In addition, in making these calls, member firms and brokers must immediately give their names, the name of their firms, their telephone number or address, and state that the purpose of the call is to sell securities or related products.

Our current rules limit what unregistered personnel may say in cold calls to three questions: (1) Would you like to come to a seminar where a registered person will discuss investments? (2) Would you like some literature about the firm? and (3) Would you like to talk to a registered salesperson? Because of concerns that some firms may be using unregistered personnel to speak to prospective customers about prohibited subjects, we recently solicited comment on a proposal to require the registration of all personnel that speak to prospective customers. The comment we have received on this proposal suggests that a more effective approach may be to focus less on registration -- which may be a fairly limited tool in combating the more egregious cold calling abuses -- and to focus more on heightened supervision of the individuals making these calls, whether the individual is an employee of a member firm or is employed by a telemarketing company retained by a member firm to make cold calls. We are studying these comments to determine the most effective regulatory approach to combat abuses in this area.

Electronic Media and The Internet

The use of electronic media -- including the Internet and e-mail -- to disseminate securities related information has grown enormously. This is an area of concern to NASDR. We will soon implement an automated system that greatly increases the range, speed, and early warning capabilities of our Internet surveillance. This prototype, named "The Internet Surveillance System" (also known as "NetWatch"), will monitor the Internet in search of individuals disseminating potentially false or misleading information about Nasdaq and OTC issues through this medium. The system will scan a list of web sites and Usenet newsgroups on a daily basis. Using advanced natural language processing tools, the system will identify references to companies and issues within the retrieved text and perform a numerical analysis on the frequency of citations to determine if an issue has an unusually high level of discussion. The staff will analyze the data that generated the notification and search through hyperlinked texts to determine if potential regulatory issues requiring further review are present. The system will also archive Internet data so that if an issuer deletes information from its home page, the analyst will be able to retrieve historical data.

In addition to enhancing our technology, we have filed proposed rule changes with the SEC that require member firms to establish written procedures for the review of electronic correspondence, which are discussed in NASD *Notice to Members 98-11*.

Nasdaq Initiatives

To ensure the continued integrity of The Nasdaq Stock Market, NASD is committed to the highest quality listing qualifications program. Although the Nasdaq SmallCap Market represents only 3.1% of the Nasdaq's total market value, it devotes considerable energy to its SmallCap qualifications program. In that regard, it has recently increased its listing standards, added significant staff, and continues to aggressively evaluate current and prospective SmallCap issuers to ensure full compliance with Nasdaq listing standards.

New Listing Standards

In August of last year the SEC approved new listing standards for Nasdaq listed companies. These standards raise financial listing requirements significantly, eliminate issuers with a bid price below $1.00, and also extend corporate governance standards to all Nasdaq listed companies. These listing standards will continue to improve the quality of smaller issuers on The Nasdaq

Stock Market, and make it even more difficult for Nasdaq securities to become the target of abusive schemes.

Increased Resources

Over the last year, Nasdaq has significantly enhanced resources by increasing Listing Qualifications staff by 36 percent and has scheduled an additional 20 percent increase for this year. It has also created and staffed a new Listing Investigations Department – a group of accountants, investigators and lawyers who will proactively investigate the financial reports, business plans and other filings of companies suspected of potentially fraudulent behavior. Investigations conducted by the Department will focus on issuers that otherwise comply with Nasdaq's listing standards, but may have issued false financial statements or otherwise engaged in fraudulent conduct to become or remain listed on Nasdaq. In addition, Nasdaq is completing development of an automated risk assessment system. This system, which uses advanced computer analysis, identifies companies with compliance profiles that suggest the need for heightened scrutiny.

Review Activities

Nasdaq continues to enforce its listing standards aggressively. In 1997, the Listing Qualifications Department denied 43 percent of applications received for listing on the Nasdaq SmallCap Market. Of these applications, 52 percent were denied based on Nasdaq's identification of public interest concerns, including problematic bridge financing and underwriter regulatory issues (e.g., Stratton Oakmont, Maidstone).

Investor Education

Investor protection initiatives through new rule proposals have been one of our highest priorities. NASDR believes that one of the most effective ways to protect individual investors is to provide them with information they need to make educated and sound investment decisions. We have coupled our initiatives with an enhanced investor education and outreach program through our Office of Individual Investor Services. This Office was launched by the NASD in August 1996 and given a mandate to help focus the attention of the organization and industry on the individual investor. Through this Office, the individual investor has a strong advocate within our organization.

The foundation of this program is the NASDR Web site (www.nasdr.com). This site provides investors a basic primer on how the regulatory process works,

how investors can avoid problems before they occur, and steps they can take should they run into difficulty. The site contains an overview of NASDR's activities, information on investing wisely, timely messages on current regulatory developments, and descriptions of the arbitration and mediation process. It also allows investors the on-line ability to request disciplinary histories of brokers, file complaints, and comment on proposed rules.

Noting the importance of this information to investors, we have recently expanded the information available to investors about the disciplinary history of a member firm or an associated person on our toll free Hotline. This Hotline permits investors — without charge — to check out an individual or firm's regulatory history, including prior violations, before doing business with them. In 1997, new rules went into effect by which we now publicize disciplinary complaints at the time they are filed and non-final "trial level" decisions in cases involving designated investor protection rules and statutory provisions. As of January 1, 1998, a new rule requires that NASD members with customer accounts must inform their customers in writing, at least annually, of the Hotline number, the NASDR web site address, and the availability of a brochure on our Public Disclosure Program. In the first quarter of this year, we plan to provide the public on-line query capability, via the NASDR web-site, of broker and firm employment-related information.

Our Web site is complemented by the NASD's Individual Investor Services site (www.investor.nasd.com), which offers training on investment basics, guidance on working with a broker, market research, and a calendar of investor events. In addition, the NASD publishes an investor newsletter, makes presentations, and provides information at investor forums. And, continuing to focus our efforts on the use of electronic media, NASDR initiated an Internet Education program. The key element of this program is a brochure distributed free to investors through the NASD and its member firms either on-line or by mail. This brochure provides guidelines for using securities information on the Internet safely.

Another way in which the NASD is trying to educate investors so that they can protect themselves are two pieces of literature that we have created titled "There are Rules to Protect You When Stockbrokers Call" And "What To Do If A Broker Calls To Pitch An IPO (Initial Public Offering)." These short pieces are designed to be distributed widely to consumers as envelope stuffers or short items in newsletters, to inform them of the requirements placed on brokers making sales calls in general or calls for an IPO in particular.

NASDR's Future Efforts

A strong regulatory response is needed to the problems in the microcap market. The NASD has already made this area a prime focus of our regulatory program, but we plan to expand our efforts even further. The NASD has actively studied this market, particularly the OTC Bulletin Board, to determine what additional rule changes and enforcement initiatives are needed to address the problems we see.

Investors need to have access to more accurate and current information about the companies whose shares are quoted on the OTC Bulletin Board. Too often the only information investors have about these issues is the misinformation and hype posted on a stock promoter's Web page or the pie-in-the-sky promises made by a brash cold-calling broker. We believe that companies that are unwilling or unable to provide full and timely disclosure of information to the public or to regulators should not be given quotation visibility on the electronic medium of the OTC Bulletin Board.

We are also acting to strengthen the tools we have to keep the shares of bogus companies from being quoted in the over-the-counter market in the first place. This can be accomplished by toughening and clarifying the rules we have to prevent broker-dealers from initiating or continuing to quote an OTC security when they do not have current reliable financial and other information about the issuer. In addition brokers should be required to disclose to their customer's specific information about these types of investments and their differences from those traded on The Nasdaq Stock Market or the exchanges.

Finally, we are becoming more proactive in educating investors on the specific and unique characteristics of the OTC equities markets. The NASD has already begun a program to educate investors about the specific characteristics of the OTC Bulletin Board, the Pink Sheets, and other quotation media. The program will describe to investors the risks associated with the OTC equities marketplace, including that certain issuers in this marketplace are not subject to listing or maintenance standards.

The NASD Board announced on December 11, 1997 that it had approved solicitation for comment on a series of proposed changes for the OTC Bulletin Board and the OTC market. The principal changes, which are subject to approval by the SEC, would enhance investor protection by significantly increasing the amount of timely and accurate information about the companies that are quoted on the Bulletin Board. They would also require brokers to take additional steps prior to recommending or conducting a transaction in an OTC security. The NASD is

now seeking comment from investors, regulators, and other groups on each of the three proposals, prior to submission to the SEC. The NASD proposals will:

- Allow only those companies that report their current financial information to the SEC, banking, or insurance regulators to be quoted on the Bulletin Board. The rule proposal will provide for a phase-in period for those securities already quoted on the OTC Bulletin Board.

- Require brokers, before they recommend a transaction in an OTC security, to review current financial statements on the company they are recommending.

- Prior to the initial purchase of an OTC security, require that every investor receive a standard disclosure statement (prepared by the NASD) emphasizing the differences between OTC securities and other market-listed securities.

In addition to these three changes, the NASD is also considering adopting additional changes, such as seeking the authority for the NASD to halt trading in Bulletin Board securities under certain circumstances, including when a foreign regulators issues a quote halt in the stock for regulatory purposes.

Thank you for the opportunity to respond to the concerns expressed in the *Business Week* article of December 15. Please do not hesitate to contact us if you need any further information on our efforts in the microcap area.

Sincerely,

Mary L. Schapiro

Mary L. Schapiro
President

cc: Frank Zarb

NASD®

National Association of Securities Dealers, Inc.
1735 K Street, N.W.
Washington, D.C. 20006-1506
(202) 728-8000

February 9, 1998

Ms. Consuela Washington
Minority Counsel
Committee on Energy and Commerce
2322 Rayburn House Office Building
Washington, D.C., 20515-6115

Dear Ms. Washington:

On January 23, 1998, NASDR President Mary Schapiro sent a letter responding to Congressman Dingell's December 12, 1997 request for a response to the December *Business Week* article titled "Ripoff! The Secret World of Chop Stocks — and How Small Investors Are Getting Fleeced."

Since we filed that letter, we have announced our order against A.S. Goldmen and Company, a case similar to those reported in our January 23 letter. Please augment our January 23 response to include the enclosed announcement of the Goldmen case.

Sincerely,

John H. Komoroske

John H. Komoroske
Director
Congressional/State Liaison

Enclosure
cc: Frank Zarb
Mary Schapiro
Elisse Walter
Barry Goldsmith
Richard Ketchum

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NASD REGULATION
An NASD Company

Press Release

National Association of Securities Dealers, Inc.
1735 K Street, NW
Washington, DC 20006-1500

For Release: Tuesday, February 3, 1998
Contact: Michael Robinson - (202) 728-8304

NASD Regulation Fines A.S. Goldmen & Co. $200,000 and Orders $1 Million-Plus in Restitution to Customers; President, Vice President, and Trader Also Sanctioned

Washington, D.C.—NASD Regulation, Inc., today ordered A.S. Goldmen & Co., Inc., to pay a $200,000 fine and more than $1 million in restitution and interest to more than 500 customers in at least 35 states.

Three of A.S. Goldmen's officials were also sanctioned. President and owner Anthony J. Marchiano was suspended from the brokerage industry in all capacities for six months, fined $50,000, and censured; Vice President Stuart E. Winkler was suspended for two years, fined $50,000, and censured; and trader Stacy Meyers was suspended for 90 days, fined $5,000, and censured. All three must retake their exams to re-enter the brokerage industry.

After an eight-day hearing, NASD Regulation's District 10 Business Conduct Committee (DBCC) found that the Iselin, N.J.-based A.S. Goldmen manipulated the price of warrants in Innovative Tech Systems Inc., received excessive underwriting compensation, charged its customers excessive mark-ups in connection with the initial after market trading of the warrants, and did not adequately supervise its staff to prevent these violations. The manipulation and the overcharging, which occurred over a four-day period from July 26 through July 29, 1994, resulted in more than $1 million in illicit profits.

NASD Regulation found no evidence that Innovative Tech Systems, which was (and still is) listed on The Nasdaq Stock Market's Small Cap Market at the time, knew that the price of its shares was being manipulated.

The abuses at A.S. Goldmen were uncovered by a lengthy NASD Regulation investigation by the Market Regulation and Enforcement Departments, and the District Offices in New York and Denver.

NASD Regulation found that A.S. Goldmen controlled the supply of Innovative Tech's warrants, through its own accounts and its customers' accounts, immediately following the company's Initial Public Offering (IPO) on July 26, 1994.

Prior to the IPO, Innovative Tech provided 1.3 million warrants to 21 bridge financiers. Within the first two hours of trading on July 26th, A.S. Goldmen purchased most of the 1.3 million warrants held by the bridge financiers below quoted prices. By adding these warrants to the almost 1.8 million remaining warrants held by the firm in its customers' accounts, A.S. Goldmen dominated and controlled the market for Innovative Tech's warrants.

A.S. Goldmen artificially increased the warrant's price to almost $2 per share, more than a 700 percent increase over the offering price. As a result, customers were charged mark-ups of 5 to 140 percent. NASD Regulation considers mark-ups in excess of 10 percent to be fraudulent.

NASD Regulation found that even though A.S. Goldmen was only one of 12 market makers in Innovative Tech, sales between the firm and its customers accounted for approximately 97 percent of all the warrants traded.

A.S. Goldmen was also found to have violated NASD rules and federal securities laws that

prohibit any firm from simultaneously bidding for and purchasing a security, while distributing it.

In addition, A.S. Goldmen received more than $750,000 in excessive underwriting compensation. NASD rules set strict limits on the permissible level of underwriters' compensation.

NASD Regulation found the following violations:

- Anthony J. Marchiano – Failed to supervise.
- Stuart E. Winkler – Engaged in manipulative trading while the firm was distributing the warrants, charged fraudulently excessive mark-ups, charged excessive underwriting compensation, and failed to supervise.
- Stacy Meyers – Charged excessive mark-ups.

Initial actions, such as this, by an NASD Regulation DBCC are final after 45 days, unless they are appealed to NASD Regulation's National Adjudicatory Council (NAC), or called for review by the NAC. The sanctions are not effective during this period. If the decision in this case is appealed or called for review, the findings may be increased, decreased, modified, or reversed.

In this case, the more than 500 investors will receive restitution payments from A.S. Goldmen within 120 days of the final decision.

NASD Regulation's DBCCs are comprised of elected representatives from the securities industry who serve three-year terms.

Investors can obtain the disciplinary record of any NASD-registered broker or brokerage firm by calling (800) 289-9999, or by sending an e-mail through NASD Regulation's Web Site (*www.nasdr.com*).

NASD Regulation oversees all U.S. stockbrokers and brokerage firms. NASD Regulation, and The Nasdaq Stock Market, Inc., are subsidiaries of the National Association of Securities Dealers, Inc. (NASD®), the largest securities-industry self-regulatory organization in the United States.

For more information on NASD Regulation, visit the Web Site (*www.nasdr.com*).

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NASAA

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February 6, 1998

The Honorable John D. Dingell
Ranking Member
Committee on Commerce
2322 Rayburn HOB
Washington, DC 20515

Dear Congressman Dingell:

Of the many issues confronting state securities regulators today, micro-cap fraud is one of our top priorities. The North American Securities Administrators Association, Inc. ("NASAA")[1] appreciates the attention you are bringing to the issue of fraud in this market segment, and thanks you for the opportunity to outline our perspective, our remedial efforts to date and our suggestions and plans for corrective measures yet to come. We look forward to working with you and the U.S. General Accounting Office to provide whatever information we have on this issue.

Micro-cap fraud is not a new problem for state regulators; in one form or another, it has plagued investors in the more speculative markets for many years. Most recently, its roots can be traced to the penny stock scams prevalent in the seventies and eighties; though in many respects, the problems in the micro-cap markets of today have grown more grave because of savings and investment patterns and market conditions.

This letter outlines what we believe to be the problem, its origins, and the states' responses. We will set forth the remedial actions states have undertaken, both individually and collectively, through NASAA, that pertain to micro-cap fraud.

THE PROBLEM

First, what do we mean by the "micro-cap" market? "Micro-cap," includes penny stocks, and generally describes the low-priced securities of small companies with market capitalizations of less than $300 million. Most of the micro-cap stocks we are concerned about are thinly-traded, risky stocks issued by start-up companies with little or no earnings. The vast majority trade on the Nasdaq Small-Cap Market, the Over-The-Counter Bulletin Board, or in the "pink sheets," a market data service previously printed daily on pink paper, and now available on electronic data feeds from private vendors.

[1] The oldest international organization devoted to investor protection, the North American Securities Administrators Association, Inc., was organized in 1919. It is a voluntary association with a membership consisting of the 65 state, provincial and territorial securities administrators in the 50 states, the District of Columbia, Canada, Mexico and Puerto Rico. In the United States, NASAA is the voice of the 50 state securities agencies responsible for grass-roots investor protection and efficient capital formation.

Micro-cap fraud stems from the systemic employment of abusive sales practices by firms marketing low-priced and highly speculative securities over the telephone. These firms may be easily distinguished from their legitimate Wall Street counterparts by their inattention to compliance matters and their disregard for the financial welfare of their customers. NASAA's investigations revealed that in many cases the brokers of the penny stock firms of the eighties are now the head traders, principals or chief executives of the micro-cap firms of today.

Problem firms creating the fraud generate a significant percentage of their revenues by underwriting initial public offerings ("IPOs") in micro-cap stock. The IPOs they structure are often positioned to present opportunities for manipulation. Additionally, transactions in the securities in which these firms make markets are often characterized by heavy mark-ups, sometimes as high as 30%. This results in extreme transaction costs even though customers are routinely told they will not be charged commissions. Often, when customers experience a dramatic price decline and place sell orders, these orders are ignored, leaving the investor with significant losses.

Abusive and high-pressure sales practices appear to be part of the corporate culture at these firms. Long-term customer relationships are rare. Formal compliance training and substantive schooling in sound market techniques and customer service are replaced by sophisticated cold-calling methods. Scores of unlicensed solicitors, employing elaborate scripts, persistently call their prospects until they agree to invest in the micro-cap stock du jour. Often there is no expectation of servicing the account beyond that initial trade.

Lastly, though geographic location of these firms is diverse, there seems to be a concentration of these firms in the New York City metropolitan area. In sales scripts seized by state regulators and taped transcripts of actual cold-calls, the firms located in this area take every advantage of their "Wall Street" proximity, trading on the name of the Street to bolster their credibility and reputation. We have also discovered that the potential investor is lured into a false sense of comfort by the frequent use of names of well-respected and recognized Wall Street firms. In their affiliation with these micro-cap firms, the clearing firm performs nothing more than administrative services and has no supervisory responsibilities for the activities of the introducing brokers.

All the above characterizes the problem we have come to know as micro-cap fraud.

CONTRIBUTING FACTORS

We believe the fundamentals are in place for a bull market in fraud. There are several reasons. Today one in three households invests in securities. An even more telling statistic: 31% of U.S. household financial assets are invested in equities, either directly, or indirectly through mutual funds, up from 17% at the end of 1990.[2] To an extent this has helped fuel the bull market itself.[3] Of course, these waves of new market participants have, in part, fueled dramatic market performance of recent years (the Dow Jones Industrial Average doubled in two and a half years, from 4,000 in February, 1995 to 8,000 in July, 1997).

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[2] Investment Company Institute, 1997 Mutual Fund Fact Book.

[3] Annual share volume on the New York Stock Exchange ("NYSE") rose from 51 billion shares in 1992 to 121 billion shares in 1997. The Nasdaq's growth from 48 billion shares in 1992 to nearly 149 billion in 1997 was even greater. The Nasdaq small-cap market volume remained rather stable at approximately 13 billion shares.

As a practical matter this shift in savings patterns has resulted in an ever-growing number of less sophisticated investors entering the marketplace. At the same time, investors are seeking ever-increasing returns on investment without a careful analysis of the risk/reward balance. In October of 1997, Montgomery Asset Management reported results of an investor survey that found that investors expected their portfolios to produce average returns of 34% annually over the next ten years.[4] This number appears to NASAA to suggest that individual investors are placing heavy emphasis on returns at the expense of risk tolerance.

Therefore, we have parallel trends of an aggregate lower level of sophistication in the market coupled with unrealistically high expectations on return on investment. This creates the perfect environment for fraud and abuse.

What's more, millions of new individuals investing in the markets create a greater demand for salespersons. A five-year review indicates the number of representatives registered with the NASD jumped from 426,979 in 1992 to over 565,000 in 1997.[5] And it is our belief that regulatory resources have not kept pace with this growth.

RISING COMPLAINTS

In 1997, many states received an increasing number of complaints from the investing public compared to 1996 levels. State securities regulators, we should note, act as a kind of "early warning radar" tracking brokers and underwriters engaging in abusive sales tactics. NASAA finds the increasing number of complaints in certain states revealing because a burgeoning stock market with high returns generally means investors are content and refrain from logging complaints with their state regulators.

The most frequent complaints received involve high-pressure calls from brokers, brokers who refuse to sell a stock when directed, brokers who make unauthorized trades and brokers who make unsuitable recommendations. A sampling of states reporting higher numbers of investor complaints to the state securities agencies include:

STATE	1996	1997
Connecticut	219	238
Georgia	563	620
Idaho (investigations and inquiries)	565	803
Illinois	800	1221
Massachusetts	372	526
New Jersey (requests for assistance)	1527	2012
New York (inquiries and complaints)	3100	4300
Pennsylvania	111	133

[4] Montgomery Asset Management press release, October 6, 1997.

[5] Nasdaq Market Data.

STATES' RESPONSE TO COMPLAINTS

At the NASAA Annual Conference in September of 1996, these complaints became an informal topic of conversation among state regulators; it was apparent a systemic problem was developing.

Later that fall, NASAA's Board of Directors authorized a special project to address the issue of fraudulent sales practices in the micro-cap marketplace. In January of 1997, NASAA created a task force made up of representatives from 12 states. The task force was then divided into teams, each targeting a particular micro-cap firm. Branch offices and additional firms in other states were scheduled for audits as well.

In February, 1997, audit teams from these states examined five firms in the New York metropolitan area. Concurrently, other states conducted similar investigations. Ultimately 20 states participated in taking actions, with NASAA serving as the coordinator for this nationwide examination of dealers selling micro-cap stocks.

At a May 29, 1997 news conference with the New York and New Jersey Attorneys General, NASAA announced that 20 state securities agencies had filed 36 actions against 14 micro-cap firms—the largest-ever coordinated state enforcement initiative aimed at a particular market sector.

What the NASAA team found was a disturbing cottage industry of cold-callers, boiler rooms and nonexistent analyst reports used to hype micro-cap stock.

THE SWEEP UNCOVERED FOUR SYSTEMIC ABUSES:

ABUSIVE COLD-CALLING PRACTICES

All of the firms relied on high-pressure, scripted telephone cold-calling practices. Many operations were classic boiler rooms with long tables and up to seven phone stations per table. Unregistered cold-callers were found in all of the firms. The scripts seized demonstrate the nature of the problem. Here is a quote from a script used by cold-callers at Investors Associates, Inc., "Perhaps a 100% return in 20 minutes sounds a bit unrealistic, but I assure you that's exactly how all of our IPOs ("Initial Public Offerings") trade."

SALES PRACTICE ABUSES

Unauthorized trading was rampant at all the firms examined by the states. Examiners found that firm and branch records were falsified. In order to mask unregistered sales by cold-callers, customer account forms were marked with a number from a registered representative with whom investors insist they never dealt. The firms systematically failed to execute customer sell orders, made unsuitable recommendations, employed unethical high-pressure sales tactics and displayed a general disregard for the accepted role of compliance procedures which the securities industry is required to maintain. For example, at one firm all the cold-callers were on the first floor with no supervision at all.

FAILURE TO REPORT INVESTOR COMPLAINTS

State examiners found hundreds of unreported customer complaints. Most of the firms failed to maintain centralized procedures for handling and reporting customer complaints to regulators, as required by law. Unauthorized trades were so common that state examiners found fill-in-the-

blank forms these firms used to respond to customer allegations. The forms contained blanks for the stock name; its value; and the reason for the unauthorized trade. One firm had reported just one complaint to the NASD Regulation, Inc. ("NASDR") from 7/96 through 2/97 but examiners uncovered over 90 unreported complaints on site.

EVASION OF BROKER-DEALER REGISTRATION REQUIREMENTS THROUGH USE OF THIRD PARTY FRANCHISE AGREEMENTS

Brokers and firms are required to register in the states in which they transact business. This requirement is absolute unless an exemption is available. When firms are transacting unregistered business it is a sure sign of problems--including avoidance of certain record-keeping requirements relied on by state regulators to protect their citizens. Examiners found that some firms claimed their branches were "franchises" in order to evade the state supervisory and record-keeping requirements.

STATE FOLLOW THROUGH ON MICRO-CAP SWEEP

Other actions continue to follow as a result of this project. The 20 original states were joined by 13 more and, to date, have together filed 81 final actions and have an additional 11 actions pending. A complete list of the actions taken against six of the firms is included as Tab 2.

Later in the summer of 1997, The New York State Attorney General convened a series of public hearings to gather additional facts regarding the scope of this problem. The hearing panel received testimony from 27 witnesses and interviewed approximately 12 others. The following state regulators submitted written testimony and is included as Tab 3: California, Delaware, Hawaii, Illinois, Indiana, Maryland, New Hampshire, Ohio, Oklahoma, Pennsylvania, South Carolina, Tennessee, Texas, Vermont, and Washington.

The hearings showed that some micro-cap firms specifically target unsophisticated investors. The victims are often the elderly, who are more likely to be home when the phone rings, less likely to hang up, and more apt to fall prey to high-pressure telemarketing techniques.

Many of the firms targeted, employ brokers who frequently move from one micro-cap firm to another. It is not uncommon for these brokers to have a history of regulatory actions and numerous customer complaints. The hearings also found problems with unregistered cold-calling.[6]

ONGOING ROLE OF THE STATES

THE PRIMARY MISSION OF STATE REGULATORS IS TO PROTECT INDIVIDUAL INVESTORS

State securities agencies are often the first contacted when individual investors have questions or concerns. Consequently, much of our focus is placed on the individual investor. While our federal counterparts are well-equipped to focus on broad national market issues, state regulators specifically focus on the protection of individual investors.

STATE LICENSING FUNCTION SERVES TO SCREEN OUT PROBLEM BROKERS

State agencies devote an ever-increasing level of resources to the function of screening out problem brokers. This is detailed in the NASAA submission to the Securities and Exchange

[6] New York State Attorney General's Report on Micro-Cap Stock Fraud.

Commission ("SEC") in connection with a mandated study under the National Securities Markets Improvement Act of 1996[7] on the uniformity of state licensing requirements of associated persons of registered brokers and dealers[8]. The dual roles of cracking down on fraudulent brokerage houses and screening out problem brokers often go hand in hand.

OVERSEEING BOTH THE SALES PERSONNEL AND THE PRODUCTS THEY SELL IN THIS SEGMENT OF THE MARKET IS A SIGNIFICANT PART OF THE OVERALL STATE ROLE

The micro-cap stocks sold by these firms are subject to state registration and review. Unlike mutual funds and stocks trading on the AMEX, Nasdaq NMS and NYSE, these predominantly regional stock offerings must be registered in order to be offered or sold in a state. As discussed above, all the sales personnel of these micro-cap dealers also must be licensed and reviewed. Therefore, this lower tier of the market receives the greatest amount of state regulatory scrutiny.

OTHER STATE INITIATIVES

State regulators combine a variety of tools and procedures in their anti-fraud efforts, both at the front-end through licensing, review of securities offerings and other investor protection efforts and after-the-fact through enforcement actions. In addition, states are making administrative changes and restructuring their operations to more effectively target the problem of micro-cap fraud. Many states have developed model programs in these areas. The programs represent various methods and procedures that have been developed and tailored to the specific state needs and resources. The cumulative effect is a critical national framework of local regulation. What follows is a brief description of several such efforts from a few select states.

STATE LICENSING OF BROKER-DEALERS AND THEIR AGENTS

MAINE

In 1988, Maine instituted a program to increase the scrutiny of all broker-dealer applications, particularly applications where the firm or any of its owners, officers or directors had been involved with penny stock firms that had exhibited a propensity for sales practice abuses. Over the years this policy has shielded Maine investors from well-known micro-cap firms such as First Jersey Securities, Blinder Robinson, Stratton Oakmont and H. J. Meyers & Co. Maine's program includes reviewing the types of products the firm has sold in the last year, how those products are selected, who in the firm is responsible for researching the products to be sold, and the policies the firm has in place to ensure that the products are only sold to suitable investors. In addition, if the sales force is going to conduct cold-calls, the state has insisted that all callers be licensed before placing calls into Maine.

Of firms subject to the NASAA sweep last spring, Maine licensed only five of the 14 firms (see page 4). One of the remaining five was subject to a conditional licensing agreement. A revocation has been filed against another.

In 1997, Maine received 161 broker-dealer applications and received 57 requests from broker-dealer applicants to withdraw their applications. Withdrawal of an application is often a mutually agreed-upon resolution when an applicant is unacceptable. While some of the 57

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[7] 104 Pub. L. No. 104-290, 110 Stat. 3416 (1996) (to be codified in various sections of 15 USC).

[8] See NASAA reports (CCH) ¶13046 (Sept. 1997).

broker-dealers that withdrew may have applied in an earlier year, the statistics have remained fairly consistent with a withdrawal rate of 25 to 35% of all broker-dealer applications filed.

COLORADO

Colorado records indicate that about 341 of the 68,644 sales representative licensing applications received by the Securities Division over the last two fiscal years (FYs 95-96 and 96-97) were withdrawn by the applicant or firm following an inquiry into reported disciplinary issues. The Division estimates that about 75% of those withdrawn applications were filed by individuals and firms involved in the "micro-cap" market.

Since Colorado enhanced its securities registration disclosure requirements and added escrow requirements for "blank check" offerings in 1990, the state has fought an ongoing battle with penny stock and "blank check" promoters. The offering documents describe what purport to be a real business, but in reality these entities are nothing more than empty shells designed to provide a vehicle to the public markets which is easily manipulated.

In summary, much of the regulatory effort exerted in Colorado against old and new penny stock operators, now dubbed "micro-cap" operators, is very difficult to quantify. However, the practical result has been that the combined efforts of federal, state and self-regulatory organizations has led to a very real reduction in the fraudulent activities that gave Colorado such a bad reputation in the 1970s and 1980s.

FLORIDA

The Florida Division of Securities has been successful in curtailing the amount of micro-cap fraud in the state by implementing effective registration and examination programs. The Division routinely denies individuals with significant disciplinary histories, whether they are in this segment of the market or associated with New York Stock Exchange members. The information needed to deny or revoke these licenses is obtained during the course of examinations conducted on firms and individuals operating in, to, or from the State of Florida. The examination program, implemented by the Division's Regulatory Support Section, maintains a close working relationship with the registration staff in facilitating the active review of pending registrations of both individuals and firms in the state. The Division resolves concerns relating to customer complaints and registration and sales practices prior to rendering a decision on an application.

The Division also maintains close liaison with other states and with the NASDR, and the SEC regional and national offices. This exchange of "intelligence" on the movement of individuals from one firm to another and the exchange of examination documents is essential to the successful implementation of the program.

The Thomas James Associates, Inc. ("Thomas James") case exemplifies Florida's examination program. Thomas James had two branch offices in Florida on which the Division of Securities performed on-site examinations. The examinations uncovered many firm-wide unsavory practices that culminated in the Division taking action. In April, 1990, the State of Florida Department of Banking and Finance, the parent state office of the Florida Division of Securities, instituted an administrative complaint against Thomas James Associates, Inc. and 31 of the firm's registered representatives, including its principals, control persons and treasurer, which sought to revoke the firm's license and suspend many of its agents. Among other things, the

complaint alleged market manipulation; non-disclosure of material facts; unregistered agent activity; lax supervision; and not executing customer requests to sell securities.

The filing of the complaint led Thomas James to enter into a consent order with the Department of Banking and Finance. As a result of the order, the firm was forced to withdraw its broker-dealer license from Florida and agree not to reapply for registration prior to June, 1994. Various sanctions were levied against the firm's agents as well, including, most prominently, barring James' President/control person and Treasurer from registering until June, 1994 and barring the Florida branch officer managers from registering in the state for several years. Their re-licensing is predicated upon entering into a conditional registration agreement which mandates that they do not act as supervisory personnel and, in fact, receive special supervision themselves.

SOUTH CAROLINA

Rather than allowing questionable brokers to register and then wait until constituents are harmed, in 1997, South Carolina recently implemented a proactive, two-step plan to prevent broker-dealer agents with significant disciplinary problems from registering in the state.

In the first phase, all applicants for registration are screened for disciplinary occurrences via the Central Registration Depository ("CRD") database. Those applicants with three or more disciplinary occurrences are automatically sent a letter asking for a signed, sworn and notarized explanation of these incidents, as well as verification that they have no clients in South Carolina. Approximately 40% of the applicants withdraw their applications upon receipt of this letter. This "step" serves two purposes. It affords fairness and due process to the applicants, who are provided ample opportunity to tell "their side of the story," while providing an efficient screening mechanism for regulators.

The second phase is to verify that the withdrawn or denied applicants are not transacting securities business with South Carolinians. The Securities Division contacts the broker-dealers' clearing firms for account activity reports and then ascertains whether or not unregistered agents effected any transactions in the state. If the withdrawn agents engaged in such transactions, the Securities Division may send a cease and desist letter to the agent and his or her firm, or revoke the entire firm's registration and levy a fine of up to $5,000 per occurrence.

South Carolina also protects investors by using other states' revocations as grounds for revoking a broker-dealer's registration in South Carolina. For example, on January 21, 1998, South Carolina revoked the registration of Meyers, Pollock, Robbins on the basis of both Massachusetts' and Indiana's revocations.

SUBSTANTIVE REVIEW OF STOCK OFFERINGS

The Pennsylvania Securities Commission ("PSC") prepared a report on the corporate finance authority exercisable at the state level. The report analyzed the 112 filings with the PSC in Fiscal Year 1996.[9] The report is representative of the type of front-end protection afforded by those states exercising substantive review. The offerings are frequently given a rigorous vetting by state examiners due to apparent conflicts of interest and potential abuses.

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[9] Pennsylvania Securities Commission, Division of Corporation Finance, Report on Corporate Equity Offerings Filed under Section 205 of the Pennsylvania Securities Act of 1972, July 1, 1995 – June 30, 1996, dated January 29, 1997.

Examples of state substantive review include escrows of cheap stock held by company insiders, limitations on options and warrants granted, and ceilings placed on the offering expenses.

Meeting these state regulatory requirements defeats the primary mechanisms of unfair and inequitable offerings and helps to keep these IPOs from being sold to the investing public. Of the sixteen IPOs identified in the December 12, 1997 *Business Week* article, "The Mob on Wall Street," only eight were filed with the PSC. Of those eight, six were withdrawn as a result of PSC comments.

Recent changes in federal law have created an incentive for issuers to avoid initial registration in certain states, only to sell into those states in the secondary market shortly after trading commences in the IPO shares.

OTHER HIGHLIGHTS FROM THE REPORT (ANALYSIS OF 112 FILINGS WITH PSC):

Almost one-third of the offered shares (32%) were offered at a price below $5 and another 33% offered between $5.00 and $5.99.

Forty-four percent of the offerings included an accountant's "going concern" letter in which the auditor's letter expressed concerns about the issuer's ability to continue as a "going concern."

Over 75% of the offerings had losses for the most recent fiscal year.

In over 40% of the offerings, the company's promoters, officers and directors paid $.01 or less per share for their stock.

Over 45% of all underwritten offerings subject to state review were underwritten by firms with three or more incidents recorded on the CRD within the past six years.

Five firms acting as such underwriters in PSC filings were cited in the December 12, 1996 *Business Week* article, "The Mob on Wall Street."

SUMMARY OF PSC DATA

Total offerings filed	112
Offerings held for issuer response or withdrawn	75
OFFERINGS REGISTERED	**37**

As you can see, by placing substantive review criteria and resources up-front, the PSC was able to focus on the offerings with structural flaws or those potentially designed to enrich a few insiders at the expense of individual investors.

ENFORCEMENT EXAMPLES

STRATTON OAKMONT, INC.

In 1995, with the organizational support of NASAA, Alabama undertook the lead role in a multi-state investigation of the broker-dealer firm Stratton Oakmont, Inc. ("Stratton") which had its headquarters in New York State. Investigators and examiners from Alabama, Kansas, Pennsylvania, Illinois, Colorado, New Mexico, Arizona, Mississippi and Georgia, with assistance from other states, joined together in this massive investigation of the acts, practices and transactions of Stratton and its agents. This thorough investigation consumed nearly two

years, and half-a-million dollars in time and expenses to complete. As a result of this investigation, over 20 states brought actions against the firm.

The multi-state Stratton investigation presented a case study in the operations of a micro-cap fraud. Analysis of the web of financial dealings detailed how Stratton manipulated the offering to shift control of the IPO shares into the hands of a few insiders. In addition, the careers of the brokers, traders and principals were tracked to detail how the same individuals moved from one micro-cap firm to another over a period of at least twelve years.[10]

HANOVER STERLING & CO.

Hanover Sterling & Co. is another example of the states initiating actions against a firm which eventually found its NASD membership cancelled.

Beginning in October, 1993, Idaho was the first to take action against Hanover Sterling & Co., for selling into the state with unregistered agents. In June, 1994, Kansas denied Hanover Sterling & Co.'s registration. The following year, 1995, both Kansas and West Virginia brought actions against the firm for unregistered activities in their respective states. Later that year, Hanover Sterling & Co.'s broker-dealer registration was revoked or cancelled by Massachusetts, Illinois, California, Texas, and Oklahoma. Eventually, 29 states terminated the firm.

While states cannot put firms out of business nationally, they can doggedly pursue these firms until the NASD and the SEC act at the national level.

THE FOCUS ON CLEARING FIRMS

As noted earlier, state regulators have seen significant numbers of investor complaints regarding micro-cap firms and brokers. The majority of these micro-cap firms are introducing brokers and use the services of "big name" Wall Street firms to process their trades and provide their customers with account statements, confirmations and other documentation.

The number of these clearing firms is less than 800 while the number of introducing brokers is well over 5,000. Therefore, by accessing information on targeted micro-cap firms from the clearing firms, state investigations can move more rapidly and efficiently.

Given these numbers and the unique nature of the clearing business, clearing firms are in possession of information that can greatly aid the state discovery and investigations of micro-cap firms. The clearing firm as an access point is a tremendously efficient tool for the states, one that will be used increasingly in the future.

Below are just some of the abuses that clearing firm reports can assist in detecting:

Sell orders in unregistered securities;

Churning;

Patterns of unauthorized trades;

Excessive commissions; and

Detection of manipulative trading practices.

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[10] See testimony of Joseph P. Borg, Director Alabama Securities Commission, before the Permanent Subcommittee on Investigations, U.S. Senate, September 22, 1997. Testimony is behind Tab 4.

In mid-January of this year examiners from the states of Utah and Missouri visited the offices of two major clearing firms in New York City. At first, the states encountered resistance to their requests, for production of customer complaints. Production was achieved only after regulatory demand letters were issued. Utah and Missouri are currently studying the results of these clearing firm examinations; however, the examinations have already confirmed that clearing firm records provide a wealth of useful information concerning the operations of introducing micro-cap brokers. Because dozens of the micro-cap firms may clear through a single clearing firm, it can result in "one-stop shopping" for regulators.

STATES RESTRUCTURING OPERATIONS TO FIGHT MICRO-CAP FRAUD

MICHIGAN – By early 1997 Michigan's enforcement staff, which audits and investigates brokerage firms, sales agents and investment advisers, had reached an all-time low of three investigators and one supervisor. Recent hires have doubled that number. Michigan has increased the number of inspections and revised audit procedures to include review of products being sold or promoted via the Internet.

The Securities and Land Development Bureau is participating in a task force (Senior Exploitation Quick Response Team) comprised of government agencies and industry representatives to address the problem of financial exploitation of senior citizens. Task force members act as contacts for their agency when a complaint comes in. The idea is to cut through the normal bureaucracy and give special expedited treatment to complaints concerning seniors, who are especially vulnerable.

The increased staff is already producing results. In January 1998, Michigan issued three orders to show cause, which involve allegations of the sale of unregistered and nonexempt securities (almost $3 million in one case).

OHIO – Micro-cap and penny stock dealers proliferated in Ohio in the late 1980s and early 1990s. In 1993, the *Dayton Daily News* estimated that approximately 60,000 Ohioans had lost more than $100 million in penny stock investments between 1989 and 1993. Beginning in 1991, the Ohio Division of Securities devoted a majority of its resources to a two-pronged effort to eradicate low-priced stock fraud in the state.

In the spring of 1991, the Division commenced legislative efforts to strengthen the dealer licensing requirements and anti-fraud standards of the Ohio Securities Act. A similar measure was re-introduced in the Ohio General Assembly in 1993 without opposition. The Bill became law on October 11, 1994. The law tightened dealer licensing requirements and added specific anti-fraud and disclosure requirements for penny stocks.

A vigorous enforcement program was commenced in Ohio with the revocation of the licenses of AEI Group, Inc., Liberty First Securities and First Ohio Equities. The Division's highest-profile enforcement action began in October, 1992 with the execution of a search warrant at the home office of Dublin Securities, Inc., the state's largest penny stock micro-cap dealer. The search warrant uncovered evidence that led a state grand jury to return a 1,023 felony count criminal indictment against two entities and five individuals. The three defendants who chose to stand trial were convicted of a total of 152 felony counts in December, 1995.

The Ohio Division of Securities pursued both legislative initiatives and enforcement actions to fight the problem of micro-cap fraud. The drastic reduction in number of complaints received by the Division gives an indication that the Division's efforts have been successful.

OHIO INVESTOR COMPLAINTS

YEAR	# OF COMPLAINTS
1992	542
1993	1385
1994	494
1995	258
1996	241
1997	223

ILLINOIS - In February, 1997, the Illinois Director of Securities proposed to the Secretary of State that the Securities Department reorganize to more appropriately meet the challenges of technology, globalization and the National Securities Markets Improvement Act of 1996. The primary objective was to reallocate existing Department resources and recognize the functional interrelationships in the Department, cross-train employees for multiple tasks and begin to shift away from office-based registration activities and move toward field-based activities such as compliance inspections, audits and investigations. The highlights of the reorganization plan include:

A new "Audit & Compliance" Division responsible for conducting and coordinating all field examination programs for Illinois registrants. The Audit Section will conduct all for-cause audits, while a new Compliance Inspection Section will coordinate all Department personnel involved in compliance examinations. The Department intends to increase the number of compliance examinations completed each year to 1,000 or more (at least six times the current level).

The Registration Division was divided and renamed "Registration & Licensing." A Small Business Information Center will be highlighted to provide assistance to legitimate small businesses.

Streamlined Department management from 14 to 6 positions.

Established a dedicated Investor Education position within the Director's office.

THE ROLE OF NASAA

In addition to the individual states, the NASAA organization has focused on the issue of micro-cap fraud and has served as a coordinator and clearinghouse for many of these efforts.

NASAA ENFORCEMENT SECTION

The NASAA Enforcement Section has 36 members serving on five committees that cover the major enforcement areas. They are Enforcement Databases; Enforcement Policy and Zones; Enforcement Training Programs; International; and Internet.

ENFORCEMENT DATABASE COMMITTEE – Educates NASAA members on the use and benefits of the Securities Investigations Database ("SID"). Monitors and evaluates SID system performance and recommends changes, additions and upgrades to the system operator. SID currently offers

two main features a securities investigation database and specific newsgroups to facilitate communication between securities enforcement personnel.

ENFORCEMENT POLICY AND ZONES COMMITTEE – Acts as a forum to develop enforcement policy and to coordinate investigations by state securities regulators by identifying trends and priorities, developing investigative approaches and enforcement remedies and collecting and maintaining information concerning enforcement cases and resources. This committee encourages and develops regional cooperation among state, provincial and federal regulators by organizing zone meetings within the regions and by acting as a conduit for communications on enforcement matters.

INTERNATIONAL COMMITTEE – Coordinates the exchange of information with international securities regulators regarding regulation of broker-dealers, enforcement and licensing guidelines.

INTERNET COMMITTEE – Coordinates the work on the development of a timely, efficient, and cost-effective means of policing the Internet for state securities law violations by issuers, broker-dealers, investment advisers and their agents or representatives and to develop a means to record and report such violations to members and investors.

NASAA BROKER-DEALER SECTION

The NASAA Broker-Dealer Section has 20 members serving on four committees that cover the areas of broker-dealer regulation. They are Broker-Dealer Operations, Broker-Dealer Sales Practices, Continuing Education and Forms Revision and Central Registration Depository.

BROKER-DEALER OPERATIONS COMMITTEE – Develops and helps implement state policies regarding broker-dealer operations, such as developing a model definition of "branch office" and updating the broker-dealer examination module as needed. This committee is also responsible for studying the use of affidavits to uncover pre-licensed sales activities by both broker-dealers and agents and, if appropriate, draft a policy statement on this issue. The Broker-Dealer Sales Practices Committee also assists in the planning and conducting of NASAA's Broker-Dealer Training Seminar. Finally, this committee will study the feasibility of member jurisdictions issuing a multi-state license where the applicant has a clean disciplinary record.

BROKER-DEALER SALES PRACTICES – Broker-dealer sales practices are often at the heart of abuses in the micro-cap area. This long-standing committee is charged with reviewing, analyzing and proposing NASAA policies associated with marketplace developments for the delivery of broker-dealer services. Potential areas of policy development include access payments, revenue sharing, commission sharing and referral fee arrangements, soft dollar compensation and utilization and standardization of performance data reporting. This committee is also responsible for developing programs for improving the effectiveness of state broker-dealer sales practice regulation generally.

CONTINUING EDUCATION – The joint efforts of NASAA and the SROs have made the continuing education program for registered representatives a marked success. NASAA is firmly committed to this cooperative undertaking. This committee makes recommendations to the membership and the Industry/Regulatory Council regarding any changes to the Continuing Education Program ("the Program") as developed, and provides representative "subject matter experts" to develop

and refine Program questions. This committee also coordinates with the SEC and SROs in developing examination procedures, modules and training.

TRAINING PROGRAMS

Starting in the 1980s, NASAA has invested a considerable amount of time and resources on training programs and conferences devoted to enforcement, litigation and examination issues. These programs have resulted in the development and publication of a NASAA broker-dealer examiners manual and an enforcement training manual utilized by all the state agencies. These sessions and materials are made available to administrators, examiners, attorneys, investigators and other state personnel at no cost to state governments.

The Winter Enforcement Conference is an annual event sponsored by NASAA and attended by securities regulators of the States, Canadian Provinces and Territories, members of academia, and federal government officials. This meeting provides a venue for regulators to formulate, recommend and implement enforcement policy.

Since 1985, NASAA has sponsored a three-track broker-dealer training program designed for broker-dealer examiners. Track I is for new examiners and contains a basic overview of the examination process, including books and records, the federal 1933 and 1934 Acts, and examination procedures. Tracks II and III are for more experienced staff and cover such topics as: update on NASD and SEC structure; Internet sites; newsletters; enforcement roundtable; soft dollar payment abuses; and Plain-English prospectuses.

The Attorney/Investigator Training Session is designed for attorneys and investigators involved primarily in enforcement of the securities laws. The agenda includes special sessions for new personnel to introduce them to basic concepts and methods in securities law enforcement. Part of the training involves separating the group into working sessions to solve hypothetical enforcement problems drawn from actual cases.

The Investment Adviser Workshop is an interactive session designed specifically for examiners. Faculty focus short presentations on issues such as custody, discretion, marketing, compensation, disclosure and practice management critical to examiners during an inspection of an investment adviser. Presentations are followed by a "breakout" into small groups led by an experienced examiner to review the books and records of a fictitious (but typical) state-registered investment adviser. Other sessions allow the small groups to conduct "mock" audits of another (more problematic) fictitious adviser.

Litigation Training draws panelists from a broad cross-section of the securities regulatory community and addresses numerous current topics relating to securities enforcement litigation. The goal of this seminar is to assist enforcement personnel in the development of effective securities litigation skills, including criminal prosecution.

INVESTOR ALERTS/BROCHURES

NASAA regularly issues "Investor Alerts" that identify common types of schemes, scams and frauds about which investors and entrepreneurs need to know. Many of the alerts can be found on the NASAA website at www.nasaa.org under the Investor Education link. NASAA distributes brochures on these same subjects at town hall meetings and other investor education forums throughout the nation. NASAA and the Council for Better Business Bureaus have

recently re-published a book based largely on these Investor Alerts entitled *How to Be an Informed Investor.*

CRD REDESIGN

State regulators rely heavily on broker-dealer and agent information contained in the Central Registration Depository (CRD), jointly owned by the states and the NASD. This database was set up in 1981 primarily as a registration tool. It contains administrative information about broker-dealers and their agents as well as customer complaints, arbitrations and other disciplinary information. State regulators have been working closely with the NASD for the past seven years on a comprehensive redesign of the CRD that will allow it to be data fields to be "searchable" by regulators. This capability will allow states to flag problem brokers and firms for further investigation, license review or revocation. The modernized CRD, when it comes on line, will be a significant step forward for state regulators in their battle against micro-cap fraud.

FURTHER MICRO-CAP EFFORTS BY STATE REGULATORS

REGULATORY MICRO-CAP WORKING GROUP – NASAA is a member of the Regulatory Micro-cap Working Group designed to better coordinate enforcement efforts and facilitate exchange of information among the SEC, NASDR and the NYSE. Discussions will focus on preventive measures to address the micro-cap fraud problem. Several meetings are planned for the coming months.

ONGOING STATE SWEEPS – Plans for the current year include continued coordinated examinations of targeted micro-cap firms. It is anticipated that a second sweep, similar to the successful effort of 1997, will be undertaken during the first quarter of 1998.

COORDINATED REGULATORY TRAINING – The AMEX, CBOE, NASAA, NASDR, NYSE and the SEC are jointly sponsoring a training conference for securities examiners focused on the detection and examination of micro-cap fraud. The training will be developed and targeted for securities examiners with two to five years of experience. We believe it is essential to ensure that examiners are well-trained and knowledgeable with respect to current examination techniques and strategies most effective in detecting micro-cap fraud. This program complements the annual NASAA Broker-Dealer Training held in June.

IMPLEMENTATION OF NEW YORK ATTORNEY GENERAL'S REPORT ON MICRO-CAP STOCK FRAUD

As a result of the widespread and increasing number of complaints about fraudulent practices in the micro-cap area of the brokerage industry, The New York Attorney General's Office has dramatically increased the number of investigations and enforcement actions over the past two years and has submitted legislative recommendations to assist the office in combating securities fraud. Chief among the legislative recommendations of the New York Attorney General's Report (Tab 5) is the statutory authority for routine examinations and inspections of broker-dealer firms and their branch offices. Highlights of the other recommendations include administrative cease & desist authority, reciprocal subpoena authority, and enhanced licensing authority over securities professionals.

CONCLUSION

The problems in the micro-cap market are serious and growing. They should not be minimized because they are limited to a relatively small sector of the marketplace. The fraud and abuse in this market can cause catastrophic losses to individual investors and, if this problem is not

vigorously addressed, it could erode the confidence in the overall securities marketplace. Unchecked, micro-cap fraud will harm not only investors but legitimate entrepreneurs who rely on equity capital to establish and grow their businesses.

State regulators play a vital role – a role that complements that of the SEC and the self-regulatory organizations – in policing our securities markets. The states are committed to working together with regulators and industry to curb the abuses in the micro-cap area. It will take coordinated action. As this letter makes clear, we have made progress, yet much more remains to be done. In order to reinforce the projects and initiatives we've already taken, NASAA recommends the following:

- State and Federal enforcement actions filed against micro-cap firms should include actions against individual brokers and where appropriate the principals of the firm. This would make it more difficult for these individuals to stay in the securities business or to transfer to other firms.
- Sanctions must be commensurate with the harm caused. Mandatory fines without regulatory sanctions such as suspensions and revocations can be factored into the cost of operating a fraudulent investment scheme. In addition, criminal sanctions should be applied where the law allows (i.e., Texas - 1997: 116 convictions from indictments involving 69 transactions, and 1996: 60 convictions from indictments involving 102 transactions).
- SEC/NASDR recognition of state enforcement actions under Section 3(a)(30) of the '34 Act, which establishes "statutory disqualifications" that the SEC and SROs may consider with respect to revoking, suspending or denying registration to broker-dealers and their agents. The section does not specifically reference state securities actions as a statutory disqualification. Currently, the SEC and the NASDR bring their own complaints concurrently or subsequent to state actions, which can create duplication of efforts and unnecessarily drain the finite pool of enforcement resources (see Borg Testimony Tab 4, pages 12-13).
- Much more needs to be done on the investor education front. The disclosure-based system of regulation relies on the fact that if investors are well informed, they will make sound investment decisions. All investor education programs should include information on how to protect against fraud.

Thank you for the opportunity to address the important issues raised in your letter. Please do not hesitate to contact Neal E. Sullivan, NASAA Executive Director, if you need additional information, or if we may assist your study in any way.

Sincerely,

Denise Voigt Crawford

Denise Voigt Crawford
NASAA President